forthcoming in

Harvard Law Review, June '85.

# TOWARDS AN UNDISTORTED CHOICE AND EQUAL TREATMENT IN CORPORATE TAKEOVERS

Lucian Arye Bebchuk

Discussion Paper No. 5

October 1984

Program in Law and Economics

Harvard Law School

Cambridge, MA  02138

# Towards an Undistorted Choice and Equal Treatment in Corporate Takeovers

Lucian A. Bebchuk

## Abstract

The concern of this Article is with two related problems regarding the current operation of corporate takeovers. The first problem is that of "distorted choice." At present, shareholders might well tender their shares to a bidder even if they view the offered acquisition price as lower than the target's independent value. For example, shareholders might tender out of concern that in case they hold out the bid might nonetheless succeed and they might end up with low-value minority shares in the taken over target. The current distortions of shareholder choice, I suggest, lead to an inefficient allocation of corporate assets and reduce social welfare.

The second and closely related problem with which the Article deals is that of "unequal treatment." In current takeovers, the total acquisition price is distributed among the target's shareholders quite disproportionately. This disproportionate division, I suggest, is both unfair and inefficient.

These two problems have been receiving a growing attention, and the SEC is currently examining whether and how they should be addressed. The Article seeks to contribute in three ways to our understanding of these problems, and to our ability to address them. First, the Article puts forward two objectives -- "undistorted choice" and "equal treatment" -- for evaluating the performance of takeover rules. The Article explains, on the basis of both efficiency and fairness considerations, why these two objectives are both desirable and important.

Second, the article provides a detailed account of the current problems -- the current distorted choice, and the current unequal treatment. While various aspects of these problems have been discussed by a number of commentators, the Article's account is fuller and more systematic than that which is provided by the existing literature. This comprehensive account of the current problems enables a better assessment of their nature, scope, and severity; and it demonstrates the inadequacy of various remedies that have been suggested in the literature.

Third, the Article puts forward a regulatory framework that would adequately address the current problems. The Article demonstrates that the proposed regulations would attain undistorted choice and equal treatment, and would involve no significant social costs. One noteworthy element of the regulations would enable shareholders to tender either "approvingly" of "disapprovingly", and would allow a bidder to gain control only if it would attract the required number of "approving" tenders. Under the proposed regulations, shareholders who view the expected acquisition price as appropriate would make "approving" tenders, while those who view the expected acquisition price as too low (but wish to ensure receiving their prorata share in case a takeover does take place) would make "disapproving" tenders.

The undistorted choice and equal treatment objectives are proposed for corporate acquisitions in general, and not only for takeovers. Indeed, the objectives are shown to provide a unified and consistent framework for evaluating acquisition rules. Consequently, while the Article focusses on takeovers, it also discusses and evaluates both merger law and the law concerning acquisitions through open market or privately negotiated purchases.

## TABLE OF CONTENTS

TOWARDS AN UNDISTORTED CHOICE AND EQUAL

TREATMENT IN CORPORATE TAKEOVERS*

Lucian Arye Bebchuk**

February 1984

Final Revision September 1984

* This Article is planned to constitute a part of a larger work on corporate acquisitions. That work is expected to draw on the present Article, two previously published articles ("The Case for Facilitating Competing Tender Offers," 95 Harv. L. Rev. 1028 (1982), and "The Case for Facilitating Competing Tender Offers: A Reply and Extension," 35 Stan. L. Rev. 23 (1982)), and some additional work which is currently in progress.

** The Society of Fellows, Harvard University. In the writing of this Article I have incurred many debts. I should like to express my gratitude to Victor Brudney for his advice and encouragement throughout; to Bob Cooter, Deborah DeMott, Mel Eisenberg, Ron Gilson, Louis Kaplow, Mitch Polinsky, Roberta Romano, Myron Scholes, Steve Shavell, and Mary Stokes for their valuable comments on earlier drafts; to participants in workshops at the law schools of Berkeley, Duke, Harvard, Penn, Stanford, and U.S.C. for their beneficial reactions and suggestions; to Michael Bradley, Robert Case, and Dean LeBaron for providing helpful information and materials; and to Harvard Law School, Stanford Law School, and the Harvard Society of Fellows for their financial support during the period in which I worked on this Article.

## I. INTRODUCTION

In a corporate takeover, an acquirer purchases a controlling interest in a public corporation (the target) through a takeover bid -- that is, an offer made to the target's shareholders to purchase their shares for cash (a tender offer) or for securities (an exchange offer). Takeover bids are a very popular and important method of acquiring a widely held corporation. They might be best known for their role in hostile acquisitions -- a takeover bid provides the only means of acquiring a widely held corporation without its management's approval.[1/] And takeover bids have also become a very common method of consummating negotiated acquisitions.[2/]

The concern of this article is with two related problems regarding the current operation of corporate takeovers. The problem on which most of the analysis will focus is one to which I shall refer as the "distorted choice" problem. Shareholders' tender decisions in the face of a takeover bid are currently subject to substantial pressures and distortions. As will be seen, a target's shareholder might well tender his[3/] shares to a bidder even if he views the offered acquisition price as lower than the value of the independent

---

1/ See Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981); Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819 (1981).

2/ See Freund & Easton, The Three Piece Suitor: An Alternative Approach to Negotiated Acquisitions, 34 Bus. Law. 1679 (1979); Freund & Green, Substance over Form S-24: A Proposal to Reform SEC Regulation of Negotiated Acquisitions, 36 Bus. Law. 1483 (1982). Takeovers have been increasingly used in negotiated acquisitions because they enable a relatively speedy consummation of an acquisition.

3/ For the sake of stylistic convenience, I shall assume throughout that shareholders are all individuals and male. Needless to say, shareholders might actually be females or legal entities.

target (including the prospect of receiving higher offers in the future).[4/] For example, the shareholder might tender out of concern that in case he does not tender other shareholders might still tender their shares, and the bidder might consequently gain control; and if the bidder gains control, non-tendering shareholders will end up with low-value minority shares in the taken over target. Thus, the prospect of the bidder gaining control introduces a substantial pressure on shareholders to tender their shares.

Due to the pressure to tender that the prospect of a takeover introduces and to other distortions that I shall describe, a bidder might currently succeed in taking over a target even if the value-maximizing course of action of the target's shareholders would be to reject the bid. As a result, a target might well be taken over even if the most efficient use of its assets would require that the target remain independent or that it be acquired by another buyer. Consequently, the current distortions lead to an inefficient allocation of corporate assets and reduce social welfare. Furthermore, the current distortions provide the only possible justification for allowing target managements to use obstructive defensive tactics; and eliminating these distortions would thus remove the only obstacle to adopting a ban on such tactics, tactics which are very costly to both target shareholders and society.[5/]

The second and closely related problem with which this Article deals is one that I shall call the "unequal treatment" problem. In current takeovers, the total acquisition price is distributed among the target's shareholders

---

4/ See Part III, Section C.

5/ The view that the current distortions of shareholder choice might justify at least some obstructing tactics is expressed in, for example, Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. Law. 101 (1979), and Lowenstein, Prunning Deadwood in Hostile Takeovers: A Proposal for Legislation, 83 Colum. L. Rev. 249, 307-309 (1983). The costs of obstructive tactics are described in Easterbrook and Fischel, supra note 1; Gilson, supra note 1.

quite disproportionately.[6/] Some shareholders have all (or most) of their shares purchased for the bid's price, while other shareholders have all their shares become minority shares with a value lower than the bid's price. Consequently, some shareholders, largely unsophisticated investors, end up with considerably less than their prorata share of the acquisition price. This disproportionate division, I shall suggest, is both inefficient and unfair.

Various aspects of these two problems have already been discussed by a number of academic lawyers,[7/] economists,[8/] and legal practitioners.[9/] Some aspects of these problems were also recently examined by the SEC's Advisory Committee on Tender Offers,[10/] and are currently being considered by the

---

6/ See Part III, Section D.

7/ The first serious discussion of the current distortions is in Brudney & Chirelstein's insightful article, Fair Shares in Corporate Mergers and Takeovers, 88 Harv. L. Rev. 297, 336-340 (1974). See also Bebchuk, The Case for Facilitating Competing Offers, 95 Harv. L. Rev. 1028, 1039-1041 (1982); Carney, Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties, Am. B. F. Res. J. 341 (1983); Coffee, Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance, 84 Colum. L. Rev. 1145, 1183-95 (1984); Gilson, supra note 1, at 859-862; Lowenstein, supra note 5, at 307-309.

8/ See Bradley, Interfirm Tender Offers and the Market for Corporate Control, 53 J. Bus. 345, 352-356 (1980); DeAngelo & Rice, Antitakeover Charter Amendments and Stockholder Wealth, 11 J. Fin. Econ. 329 (1983); Jarrel, The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merger?, Unpublished Manuscript, The University of Chicago (Jan. 1983); Jensen & Ruback, The Market for Corporate Control: The Scientific Evidence, 11 J. Fin. Econ. 5 (1983).

9/ See e.g., Balloth & Finkelstein, "Coercive" Structures in Tender Offers, 15 Rev. Sec. Reg. 820 (1982); Lipton, supra note 5, at 113-14; Greene α Junewicz, A Reappraizal of Current Regulation of Mergers and Acquisitions, 132 U. Penn. L. Rev. 647, 676-693 (1984).

10/ See Securities and Exchange Commission Advisory Committee on Tender Offers, Report of Recommendations 24-26 (July 8, 1983) (hereinafter cited as the Advisory Committee Report).

SEC.[11/] The present Article seeks to contribute to our understanding of these problems -- and to our ability to address them -- in the following three ways.

First, the Article puts forward two objectives -- "undistorted choice" and "equal treatment" -- for evaluating the performance of takeover rules. According to the undistorted choice objective, a target should be acquired if and only if its shareholders (or at least shareholders holding a majority of its shares) judge the offered acquisition price to be higher than the target's independent value. According to the equal treatment objective, the total acquisition price in a takeover should be distributed among the target's shareholders in proportion to their holdings. The Article explains, on the basis of both efficiency and fairness considerations, why these objectives are both desirable and important. And it shows that these objectives are capable of providing a unified and consistent normative framework not only for takeovers, but for corporate acquisition in general.

Second, the Article provides a detailed account of the current problems -- the current distorted choice and the current inequality of treatment. While various aspects of these problems have been previously discussed, the Article's account is fuller and more systematic than that which is provided by the existing literature. The Article's account shows that various common views regarding the current distortions of shareholder choice rest on misconceptions of the distortions' nature and operation; for example, the problem of distorted choice is not limited, as is frequently thought, to partial bids or to bids which are expected to be followed by immediate takeouts, but is present in all

---

11/ See Statement of John R. S. Shad, Chairman of the Securities and Exchange Commission, Before the House Subcommittee on Telecommunications, Consumer Protection, and Finance [Current] Fed. Sec. L. Rep. (CCH) §83,511, at 76,679 (April 4, 1984) (hereinafter cited as Statement of Shad); Securities and Exchange Act Release No. 21079 [Current] Fed. Sec. L. Rep. (CCH) §83,637 (June 21, 1984) (hereinafter cited as SEC Release).

bids.[12/] The Article's comprehensive and systematic account thus enables a better understanding of the nature, operation, scope, and severity of the current problems.[13/] Furthermore, the Article's analysis of the current problems demonstrates the inadequacy of various remedies that have been suggested in the literature.

Third, the Article puts forward a regulatory framework that would effectively address the current problems of distorted choice and unequal treatment. The proposed framework has common elements with the arrangements currently prevailing in the U.K. The Article demonstrates that the proposed regulations would ensure undistorted choice and equal treatment, and that they would involve no significant social costs.

As the proposed regulations will be outlined only in Part V, after the analysis of the current problems is completed, it might be helpful to give the reader at this stage some sense of the proposed regulations. I would like therefore to note one important element of the proposals -- enabling shareholders to tender their shares either "approvingly" or "disapprovingly". A bidder would be allowed to buy a controlling interest only if its bid would attract the required number of approving tenders. As will be seen, under the

---

12/ See Sections III.C., IV.A, IV.B.

13/ Among other things, I show that there are two different reasons as to why shareholders' tender decisions do not reflect their judgment as to whether the expected acquisition price exceeds the independent target's value; that the possibility of gaining control with a block falling short of a majority ownership also contributes to the current distortions; that, in contrast to the received view, the current distortions are not all attributable to target shareholders' inability to coordinate their actions; that eliminating the current gap between the bid's price and the expected post-takeover value of minority shares would not attain undistorted choice; and that the current distortions inflict not only shareholders' choice between selling their company and remaining independent but also their choice among competing bids. I classify all the sources of the current distortions; and I delineate the circumstances where a distorted outcome is certain and where it is only possible.

proposed regulations shareholders would by and large tender (either approvingly or disapprovingly): those who view the offered acquisition price as appropriate would make approving tenders; those who view the offered acquisition price as too low, but wish to ensure receiving their prorata share of the acquisition price in case a takeover does take place, would make disapproving tenders. Enabling approving and disapproving tenders would work, together with other elements of the proposed regulatory framework, to address the problems of distorted choice and unequal treatment.

The Article is organized as follows. Part II describes the two objectives -- undistorted choice and equal treatment -- in light of which I shall evaluate takeover rules. While I shall suggest that the equal treatment objective is desirable on both efficiency and fairness grounds, it is worthwhile emphasizing that its acceptance is not essential to any of my reform proposals; the case for these proposals can be based on the undistorted choice objective alone, and is simply strengthened if one accepts the equal treatment objective.

Parts III - V, the major part of the Article, are an analysis showing how far we currently are from attaining the undistorted choice and equal treatment objectives, and how these objectives might and should be attained. Part III provides a detailed and systematic account of how current takeover rules lead to a greatly distorted choice and to a substantially unequal treatment. Part IV discusses various remedies that have been suggested in the literature, and explains why they are all incapable of adequately addressing the current problems. Part V outlines the regulations that I propose, demonstrates their effectiveness in addressing the current problems, and compares them to the arrangements prevailing in Britain.

Part VI explains why the undistorted choice and equal treatment objectives are both desirable and important. It points out that an undistorted choice by target shareholders is essential to an efficient operation of the market for corporate assets. It suggests that the equal treatment objective is desirable on both efficiency and fairness grounds. And it shows that ensuring undistorted choice and equal treatment, through the proposed regulations, would involve no significant social costs. I defer all these arguments to Part VI because they will rely on the preceding parts' analysis of the current problems and the proposed remedies.

While the Article focuses on takeovers, the undistorted choice and equal treatment objectives are proposed for corporate acquisitions in general, and not only for takeovers. Part VII therefore extends the Article's analysis to another acqusition method that is currently used: the accumulation of a controlling interest through open market or privately negotiated purchases. I propose that prospective buyers should not be allowed to acquire a controlling interest in this way, and should be limited to pursuing a takeover or a merger.

The problems of distorted choice and unequal treatment are rooted in the divided, often dispersed ownership of corporate targets. To focus on these important problems the Article's analysis abstracts from two other problems that corporate acquisitions might present -- distorted choice by acquirers, and distortions resulting from private gains to acquirers and targets that do not represent social gains. Part VIII discusses these problems, and explains that their presence does not weaken the case for the Article's proposed regulations, but rather suggests that the regulations should possibly be supplemented with some additional measures.

For simplicity of exposition, the Article's analysis of takeover bids limits itself to situations in which a target's shareholders face a single bid. The Appendix to the Article extends the analysis to the case where rival bids are present. The Appendix describes the additional problems that the presence of competing bids introduces, and explains how the proposed regulations should be adjusted to address these additional problems.

This is a long article, and some readers might look for shortcuts. Such readers might want to consider skipping Part IV, which points out the inadequacy of various remedies that have been suggested in the literature, and going straight to Part V, which puts forward a regulatory framework that would work. Also, if (and only if) these readers find the undistorted choice and equal treatment objectives to be intuitively appealing, they might want to consider not reading Part VI, which provides a detailed explanation of the desirability and importance of these objectives.

Finally, a note on terminology is in order. By a majority of a company's shareholders I shall throughout mean shareholders holding a majority of the company's shares. Similarly, by X percent of a company's shareholders I shall mean shareholders holding X percent of the company's shares.

## II. THE OBJECTIVES OF UNDISTORTED CHOICE AND EQUAL TREATMENT

I should like to start by describing the two objectives in light of which I shall evaluate the performance of takeover rules. Indeed, these objectives are proposed for corporate acquisitions in general, and not only for takeovers. The objectives, I suggest, are capable of providing a unified and consistent normative framework for corporate acquisitions.[14/]

By an acquisition of a target I mean purchasing all of its shares (or, equivalently, all of its assets) or at least a controlling interest in it. I shall throughout the Article limit myself to acquisitions of targets which prior to the acquisition were not controlled by a single shareholder (or a group of shareholders acting in concert). Acquisitions of targets which did have a controlling shareholder pose a special set of problems, and require a separate analysis.[15/]

### A. Undistorted Choice

#### 1. Corporate Acquisitions in General

According to the undistorted choice objective, a company should be acquired if and only if a majority of its shareholders view the offered acquisition price as higher than the value of the independent target and than other avail-

---

14/ The SEC's Advisory Committee and the SEC have recently emphasized the need for a consistent treatment of all acquisition methods. See Advisory Committee Report, supra note 10, at 9, Recommendation 10; Statement of Shad, supra note 11, at 86,678.

15/ The rules that should govern such acquisitions have been extensively debated for some time. See, e.g., Andrews, The Stockholder's Right to Equal Opportunity in the Sale of Shares, 78 Harv. L. Rev. 505 (1976); Javaras, Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews, 32, U. Chi. L. Rev. (1956).

able offers. By the value of the independent target I mean the value that the target will have if it is not acquired but rather remains independent, at least temporarily. This value of the independent target, I wish to emphasize, includes the value of the prospect of receiving higher acquisition offers in the future.

While the desirability of the undistorted choice objective will be discussed in detail in Part VI, I wish to make at this stage some brief remarks concerning this issue. The rationale behind the objective is one of efficiency. Efficiency requires that corporate assets (as well as other social resources) be allocated to their most productive uses. Some corporate acquisitions would produce efficiency gains from, say, improved management or "synergy"; other corporate acquisitions, however, might involve no efficiency gains or even produce efficiency losses. From the perspective of efficiency, it is desirable that a target will be acquired if and only if the acquisition would be value-increasing -- that is, would produce efficiency gains. The question, though, is how to ensure that this will happen.

To examine this question, let us consider for a moment how the allocation of a sole owner's assets is determined. The law generally makes the sale of a sole owner's assets conditional on the sole owner's consent. Consequently, such a sale will take place if and only if the owner views the offered acquisition price as higher than the value to himself of retaining his assets for the time being (value that includes the prospect of receiving higher offers in the future).

It is widely thought that enabling sole owners to reject acquisition offers serves efficiency. When a sole owner rejects an offer to purchase his assets, then he likely places a higher value on these assets than does the potential buyer, and efficiency will be likely served by having the owner retain his assets. To be sure, the owner might overestimate the value to himself of retaining his assets -- he might be overly optimistic about the assets' productivity at his hands or about the chances of receiving higher offers in the future. But the fact that sole owners make mistakes (in both directions) does not imply that it would be efficient to deprive them of the power to reject acquisition offers. While sole owners make mistakes, the question that they ask themselves is the one which is relevant from the point of view of efficiency: is the offered acquisition price (which reflects the value that the prospective buyer places on the target's assets) higher or lower than the value to themselves of retaining the assets? And the answer that sole owners give to this question determines their actions.

Let us now return from the sole owner context to that of the public corporation. What the undistorted choice objective suggests is that we should enable a target's dispersed shareholders to act as a sole owner would be likely to act. When the shareholders view the offered acquisition price as lower than the independent target's value -- and let us assume for a moment that they are unanimous in this judgment -- then the acquisition offer should be rejected: efficiency would be likely served by having the target remain independent. Of course, like a sole owner, the target's owners might be mistaken in their judgment of their value-maximizing course of action; they might overestimate the future profitability of the target's assets or the chances of receiving a higher offer in the future. But, again, the fact that the target's owners might make mistakes (in both directions) does not imply that it is desirable to deprive them of the ability to reject offers whose rejection they view as value-maximizing.

Now, while a sole owner obviously has only one view, the shareholders of a target might well differ in their assessment of the offered acquisition price and of the target's independent value. It would therefore be unrealistic, indeed paralyzing, to require a unanimous shareholder agreement about the value-maximizing course of action. Hence, it is necessary to specify some fraction of the target's shareholders who must view accepting the offer as value-maximizing if the offer is to be accepted.

What the undistorted choice objective suggests is that we should follow the judgment of the majority of the shareholders, on the grounds that the majority is more likely to be right than the minority. Part VI will discuss some objections to, and possible modifications of, this definition of the decisive fraction. But I wish to emphasize that one who would define the decisive fraction differently would still find the Article's analysis wholly relevant. For the analysis will focus on ensuring that shareholders' tender decisions reflect their judgment as to whether the offered acquisition price exceeds the target's independent value; and this would still be a necessary and major step even if one has a somewhat different definition of the decisive fraction of the target's shareholders. Thus, for example, the regulatory framework to be proposed could be easily adjusted to one ensuring that a company will be acquired if and only if a supermajority (rather than a simple majority) views the acquisition as value-maximizing.

Now, there might be some who would agree that the undistorted choice objective is theoretically desirable, but would question its importance. They would accept that if a target's shareholders view rejecting a bid as value-maximizing then the bid should fail; but they would doubt whether there are actual instances where a target's shareholders have such a view. In particular, they would point out that bidders usually offer considerable premiums over the target's pre-bid market price, and they would wonder why would rejecting a premium bid ever be the shareholders' value-maximizing course of action. As Part VI will explain, however, there are good theoretical and empirical reasons for believing that rejecting a bid might be value-maximizing in a significant number of cases. In particular, when the shareholders make their tender decisions, their valuation of the target might substantially differ from the one implicit in the target's pre-bid market price. The takeover process often releases a lot of new information; indeed, the very fact that a bid was made might lead shareholders to revise their estimates of the target's value.

Below I shall refer to an acquisition offer as having "majority support" if the offer is judged by a majority of the shareholders to be higher than other available offers and than the target's independent value. Using this term, the undistorted choice objective that I have proposed might be usefully divided into two parts: first, majority support should be a necessary condition for an acquisition attempt to be successful; second, majority support should also be a sufficient condition for the success of such an acquisition attempt.

2. Merger

Let us now consider, in light of the suggested general objective, the traditional acquisition method -- that of a merger. By merger I shall refer throughout to all forms of acquisition, including consolidation and sale of substantially all assets, that require an approval by the target's board and by a shareholder vote. Merger law ensures that a target will not be acquired through a merger if the acquisition does not enjoy shareholder majority support. For a merger requires a vote of approval by the target's shareholders.[16/] And shareholders presumably will not vote in favor of a merger proposal unless

---

16/ Most states require an approval by a simple majority. See, e.g., Del. Code Ann., General Corporation Law §251(c). But some states require an approval by a supermajority. See, e.g., New York, CLS Bus. Corp. Law §903(a)(1). According to the proposed general objective, the decisive majority for approving a merger should be the simple one.

they judge the offered acquisition price to be higher than the independent target's value.17/

The problem with the merger method, however, is that it cannot ensure that an acquisition offer that has majority support will be indeed accepted. This problem owes its existence to the possible divergence of interests between shareholders and managers.18/ If managers were completely loyal agents of shareholders, they would bring to a shareholder vote all merger offers that have a meaningful chance of gaining shareholder approval. In a world of perfectly loyal managers, we could make merger the only available method of corporate acquisition, and we would have no reason to create alternative methods of acquisition; for in such a world we could rely on the merger method to accomplish the objective of shareholder support being both necessary and sufficient for the acceptance of an acquisition offer.

Managers, however, are not perfectly loyal agents. They might be concerned not only with the shareholders' interests but also with their own, private interests. Consequently, management might refrain from bringing to a shareholder vote a given merger proposal that would receive shareholder approval. For management might prefer to stay independent; or it might prefer an acqui-

---

17/ There is, of course, the question whether shareholders have sufficient incentives to participate in a merger vote. But supposing that a given shareholder votes, his vote will reflect his judgment as to how the offered acquisition price compares with the independent target's value. The shareholder's vote will matter only in case it proves to be a pivotal vote; otherwise, the vote will not affect the shareholder's position. Consequently, the shareholder will vote in favor of the merger proposal if and only if he prefers the merger to take place. And since the total acquisition price in a merger is expected to be distributed prorata, the shareholder will prefer a merger to occur if and only if he views the offered acquisition price as higher than the independent target's value.

18/ *See* Easterbrook & Fischel, *supra* note 1, at 1199-1201; Gilson, *supra* note 1, at 848-852.

sition by some other potential buyer which offers a better deal for management but worse terms for the shareholders. Thus, because management controls the merger agenda, shareholder support might be insufficient to ensure that the target will be acquired through a merger. It is for this reason that it is desirable to have another acquisition method, that of a takeover.

3. Takeovers

Turning now to takeovers, the objective for this acquisition method directly follows from the general objective that I suggested for corporate acquisitions. First, since we seek to ensure that shareholder majority support be sufficient for an acquisition to take place, and since such support might be insufficient for a merger, then it must be sufficient for a takeover. Second, since we seek to make majority support a necessary condition for an acquisition to take place, then it should be in particular a necessary condition for a takeover. In sum, a bidder should succeed in taking over a target if and only if a majority of the target's shareholders view the offered acquisition price as higher than any other available offer and than the target's independent value (including the prospect of receiving higher offers in the future).

Consider first the aim of ensuring that majority support be sufficient for a takeover bid to succeed. If the target's shareholders are left free to accept the bid, then the presence of shareholder majority support will generally ensure that the bidder will receive enough tendered shares to acquire a controlling majority.[19/] A bid that would attract a majority of shares,

---

19/ As will be seen, the current distortions operate systematically in favor of bidders. Consequently, the presence of a shareholder majority support is generally sufficient but not necessary for a bid to succeed. See Part III, Section C.

however, might be currently impeded by incumbent management's use of obstructing defensive tactics (such as litigation or creation of antitrust obstacles). A self-serving management might currently employ such tactics to avoid an acquisition altogether or to enable an acquisition by management's favorite acquisition partner. It is for this reason that I support a ban on obstructing defensive tactics:[20/] such a ban is essential for the goal of ensuring that shareholder support be sufficient for an acquisition, a goal which is an integral part of the undistorted choice objective.

Consider now the aim of ensuring that majority support be a necessary condition for a takeover. This element of the proposed general objective will be the one on which the Article's analysis will focus. As the analysis will demonstrate, at present a bidder might well succeed in gaining control over a target even if its offer does not enjoy majority support. My efforts will be aimed at outlining a set of rules under which a bidder would succeed in taking over a target if and only if the bidder's acquisition offer enjoys majority support.

Having gone from the objective concerning acquisition attempts in general to the particular objective concerning takeover bids, let us now make a full circle. The legal rules that the Article will put forward, together with the ban on obstructive tactics which I endorse and with the current rules of merger law, would enable us to attain the suggested general objective concerning corporate acquisitions. The ban on obstructive tactics would ensure that an acquisition offer which enjoys majority support would be accepted whether incumbent management is loyal or self-serving. The regulatory framework that I shall put forward, together with the present requirement that a

---

20/ I have previously expressed this view in Bebchuk, supra note 7, at 1054-56; Bebchuk, The Case for Facilitating Competing Tenders Offers: A reply and Extension, 35 Stan. L. Rev. 23, 47-48 (1982).

merger be approved by a shareholder vote, would ensure that a company would not be acquired, whether through a takeover or a merger, unless the acquisition offer enjoys majority support. Thus, the regulatory framework to be outlined would be an integral part of a suggested general policy -- a policy of ensuring undistorted choice by target shareholders.

### B. Equal Treatment

The second proposed objective applies only to those instances where acquisition attempts do succeed. It concerns the distribution of the total acquisition price among the target's shareholders in such instances. The general objective that I propose with respect to the distribution issue is that of "equal treatment." According to this objective, the acquisition price should be divided among the target's shareholders in proportion to their holdings, or at least as close to a proportionate division as practically possible.

When an independent target is acquired through a merger, the acquisition price is generally divided among the target's shareholders in proportion to their holdings.[21/] The process that determines whether a merger proposal will be accepted has no bearing on how the acquisition price will be distributed if the proposal is accepted. Once a merger proposal is approved by a shareholder vote and the merger goes through, each shareholder will receive his prorata share of the total acquisition price, whether he voted against the merger proposal, in favor of it, or did not vote at all.

---

21/ Note that the Article's analysis is limited to acquisitions of companies which prior to the acquisition did not have a controlling shareholder. In current parent-subsidiary mergers, the merged subsidiary's shareholders are often treated unequally (with the parent benefitting at the outsiders' expense). The question of whether such equal treatment should be allowed is beyond the scope of this Article.

In contrast, when an independent target is currently acquired through a takeover, the target's shareholders might well be subject to an unequal treatment. As the analysis will show, the process that currently determines whether a takeover bid will succeed has a substantial bearing on the distribution of the acquisition price in case the bid is successful. And the resulting distribution might be quite disproportionate. The regulations that I shall put forward to ensure an undistorted shareholder choice, however, would also ensure a proportionate division.

Part VI will explain why equal treatment is a desirable objective not only for mergers but also for takeovers. One reason for this is that equal treatment is instrumental to attaining undistorted choice. For, as the analysis will show, the expected unequal treatment of non-tendering shareholders plays an important role in the current distortions of shareholder choice. Ensuring undistorted choice will be seen to require a more or less proportionate distribution; and it is thus no coincidence that the regulations which I shall put forward to ensure an undistorted choice would also secure an equal treatment of target shareholders.

As Part VI will suggest, however, equal treatment is desirable not only for its instrumental value but also as an independent objective, an end in itself. The argument that I shall make for the independent value of equal treatment will be based on what I view as widely held notions of fairness. These notions of fairness suggest some presumption in favor of a prorata division. The presumption is that, absent some reason to the contrary, it is fair that two shareholders who hold the same number of shares in a target will receive the same fraction of the acquisition price.

To be sure, the presumption is a weak one and can be refuted if we identify some appropriate reason for departing from prorata division in the takeover context. Professor Easterbrook and Fischel, for example, have recently expressed a concern that equal treatment in the considered context would involve substantial efficiency losses.[22/] Part VI will therefore examine whether there is in the takeover context some reason, rooted in efficiency or otherwise, for deviating from equal treatment. I shall conclude that in the takeover context neither efficiency considerations, nor entitlement or desert notions, nor overall distributive goals, appear to lend any support for departing from equal treatment. In particular, efficiency considerations will be seen to strengthen the case for equal treatment, rather than undermine it.

As I noted, the undistorted choice objective will be the one on which the analysis will focus. In saying this I do not wish to imply that the equal treatment objective is unimportant --it is in my view a very important objective. Rather, I have chosen to focus on the undistorted choice objective for the following two reasons. First, the analysis of the current choice distortions, and of the regulations necessary to address them, is simply more complicated and requires more space than the corresponding analysis of the current deviations from equal treatment. Second, while I believe that most readers will accept the equal treatment objective, it is likely that some will not. It will be therefore important to demonstrate that the proposed reforms can be all grounded in the efficiency-based undistorted choice objective alone; the equal treatment objective only strengthens (and in my view considerably so) the case for these proposals.

---

22/ See Easterbrook & Fischel, Corporate Control Transactions, 91 Yale L. J. 737 (1982).

## III. THE CURRENT PROBLEMS

This Part describes the current problems which the Article seeks to address. Section A and B analyze two preliminary issues: the value that minority shares are expected to have in case of a takeover, and the factors that shape the total acquisition price in such a case. Then, Section C and D examine the current problems of distorted choice and unequal treatment respectively.

For simplicity of exposition, I shall assume in this Part, and in Parts IV and V, that the shareholders of any takeover target face a single takeover bid, rather than competing bids. While this is indeed the most common situation,[23/] the assumption does not generally hold, as bidding contests over targets do take place. I shall employ this assumption, however, in order to focus on target shareholders' choice between selling their company and remaining independent in isolation from the choice that they might face between rival bids. The Appendix will consider the case of competing bids, and will analyze the additional problems that the presence of such bids might introduce.

### A. The Post-Takeover Value of Minority Shares

I should like to start by examining how the expected post-takeover value of minority shares generally compares with the takeover bid's price; the difference between these two values will be seen to play an important role in the analysis to follow. By minority shares I mean shares of a taken over target that are not held by the acquirer. By the post-takeover value of minority shares I mean the value that they have immediately following the

---

23/ *See*, *e.g.*, Bradley, *supra* note 8; Dodd & Ruback, Tender Offers and Stockholder Returns, 5 *J. Fin. Econ.* (1977).

successful bid's expiration, or, more precisely, at the date when shares purchased through the bid are paid for. And by the bid's price I mean the value of the consideration, whether in cash or in securities, that is paid for each share purchased through the bid.

The expected post-takeover value of minority shares obviously depends on the course of action that the bidder is expected to follow upon gaining control. Given current state corporate law, an acquirer is usually able to effect a takeout merger between itself and the target -- a merger which will eliminate the target's independent existence, and in which minority shareholders will be "frozen out" and receive instead of their shares either cash or securities of the bidder.[24/] Thus, a successful bidder might proceed upon gaining control in one of two ways. First, the bidder might promptly move to effect a takeout. Alternatively, the bidder might elect not to effect an immediate takeout but

---

24/ To be sure, a merger between the target and the acquirer requires a vote of approval by the target's shareholders. The acquirer, however, can vote its controlling interest in favor of the merger proposal. This is usually sufficient, as most states require only a simple majority to approve a merger proposal, and the acquirer's controlling interest is usually a majority interest. Even if the acquirer's controlling block falls somewhat short of a majority interest, the acquirer will often be able to pass the merger resolution. See Brudney & Chirelstein, supra note 7.

Once shareholder approval had been obtained and the other technical requirements for a merger had been complied with, courts commonly refused to grant minority shareholders an injunction against the consummation of a takeout merger. See Havender, Stauffer v. Standard Brands 41 Del. Ch. 7, 187 A. 2d 78 (Del.1962); David J. Green & Co. v. Schenley Indus. 281 A. 2d 30 (Del. Ch. 1971). In Singer v. Magnavox, 380 A. 2d 979 (Del. 1977), the Delaware Supreme Court opened the door a bit, and enabled an injunction against a takeout merger in case the acquirer can show no business purpose for the merger. But in Weinberger v. VOP, Inc. 457 A. 2d 702 (Del. 1983) the Delaware Supreme Court reversed itself, and practically eliminated the availability of injunctive relief. The Court more or less limited minority shareholders to the appraisal remedy which I shall presently discuss. See Berger & Allingham, A New Light on Cash-Out Mergers: Weinberger Eclipses Singer, 39 Bus. Law. 1 (1983).

rather maintain the target, at least for the time being, as a partly-owned subsidiary.

1. Immediate Takeout

Suppose first that upon gaining control the bidder is expected to proceed with an immediate takeout. By an immediate takeout I shall mean a takeout that takes place within a few months after the takeover. Takeovers are frequently followed by immediate takeouts; and recently takeover bids have been often accompanied by the bidder's announcement of its plans for an immediate takeout.[25/] Takeovers accompanied by an immediate takeout are referred to in takeover jargon as "two-step" acquisitions.

When shareholders expect an immediate takeout, I suggest, they will attach to minority shareholders an expected post-takeover value lower than the bid's price. For one thing, current takeout law makes it possible for the bidder to pay frozen out minority shareholders a consideration with a nominal value lower than the bid's price.

In determining the takeout consideration, an acquirer is constrained only by the appraisal rights of the minority shareholders.[26/] Appraisal statutes are not designed to give a target's shareholders any share of the gains from the target's acquisition -- such statutes generally exclude from the required compensation any element of value arising from the expectation or accomplish-

25/ See, e.g., N. Y. Times, Dec. 2, 1981, at D4, cols. 1-3 (Notice of U.S. Steel's bid for Marathon Oil).

26/ Indeed, some legislatures have even permitted elimination of appraisal rights in cases where the target's stock has an active market. See, e.g., Del. Code Ann. titl. 8, §262 (k)(1975); Pa. Stat. Ann. titl. 15, §1515L (Purdon 1982); Model Bus. Corp. Act §8 (1971). See also Note, A Reconsideration of the Stock Market Exception to the Dissenting Shareholder's Right of Appraisal, 74 Mich.L. Rev. 1023 (1976).

ment of a merger.27/ And in assessing the target's pre-acquisition value, the appraisal process draws substantially on past stock market prices and earnings.28/ Consequently, while the appraisal right might ensure that frozen out shareholders will not receive a consideration lower than the target's pre-bid price, it is highly unlikely to protect them against compensation lower than the price of a premium takeover bid.29/ Indeed, recent takeovers have been frequently followed by immediate takeouts in which minority shareholders received securities with a value substantially lower than the bid's price.30/

---

27/ See, e.g., Del, Cod Ann. titl. 8, ¶262(f) (Supp.1980); ABA-ALl Model Bus. Corp. Act ¶81 (1969). An exception is the recently reformed New York appraisal statute. See N. Y. Bus. Corp. Law §623(a)(c) (McKinney 1982).

28/ Courts have usually given weight to stock market prices, to the target's current and past earnings, and to the sale value of the target's assets. See, e.g., Note, Valuation of Dissenter Stock Under Appraisal Statutes, 45 Har. L. Rev. (1966); Chasen, Fairness from a Financial Point of View in Acquisitions of Public Companies: Is "Third-Party Sale Value" the Appropriate Standard?, 36 Bus. Law. 1439 (1981). In the recent case of Weinberger v. VOP, Inc. 457 A. 2d 701 (Del. 1983), however, the Delaware Supreme Court showed willingness to use a more flexible approach to valuation. See Berger & Allingham, supra note 24, at I6-19.

29/ It is also worthwhile pointing out the considerable procedural and technical difficulties that are involved in a shareholder's invoking his appraisal rights. In Delaware, for example, a shareholder seeking appraisal rights must (i) file a written objection to the merger prior to the shareholder meeting that approves the merger, (ii) vote against the merger in this meeting, (iii) after the meeting promptly give written notice to the corporation of his intention to pursue his appraisal remedy, and (iv) surrender his shares to the corporation. See Del. Code Ann. titl. 8 §262(j) (1982). These problems are one of the reasons why appraisal has been called "a remedy of desperation." Eisenberg, The Legal Roles of Shareholders and Management in Modern Corporate Decision Making, 57 Calif. L. Rev. 1, 85 (I969).

30/ For example, U. S. Steel acquired 51% of Marathon Oil's shares for a takeover price of $125 in cash, and then effected an immediate takeout (the terms of which were announced in advance, at the time the bid was made). In the second-step takeout, minority shareholders received debt securities of U. S. Steel that were estimated at the time of the bid at $86 (and had an even lower value when they were actually paid). See Wall St. J., Feb. 3, 1982, at 2, col. 3.

And all challenges to such pricing structures have been rejected by the courts.[31/]

Moreover, even supposing that it is expected that the bidder will elect to pay a takeout consideration with a nominal value equal to the bid's price (as has been the case in some friendly takeovers), the expected post-takeover value of minority shares will still be lower than the bid's price. For takeouts usually take place at least two months, and often considerably more than that, after the takeover. Due to the technical requirements involved in consummating a takeout, at least two months will be usually necessary even if the bidder tries to speed this consummation;[32/] and speeding the takeout's consummation is not always in the bidder's interest. Hence, the post-takeover value of minority shares will be equal to the expected takeout consideration minus an appropriate time discount.

2. No Immediate Takeout

Suppose now that upon gaining control the bidder is expected not to effect an immediate takeout, but rather maintain the target for the time being as a partly-owned subsidiary. Again, I suggest, shareholders will likely attach to minority shares a post-takeover value lower than the bid's price.

For one thing, the minority shares' post-takeover value will certainly be lower than the bid's price in the bidder's eyes. If an acquirer does not

---

31/ See, e.g., Radol v. Thomas, 534 F. Supp. 1302 (S.D. Ohio 1982).

32/ The consummation of a takeout merger requires substantial time because a vote of shareholder approval is needed. It is necessary to prepare bulky proxy statements, to file them with the SEC, to wait for and respond to the comments of the SEC's staff, and then to solicit the shareholders' votes. In most cases, materials cannot be mailed to stockholders until one month after filing with the SEC, and another month is usually required for the solicitation of votes. See Freund & Greene, supra note 2, at 1499-500.

effect an immediate takeout, then the acquirer must attach to minority shares a value lower than that of the consideration that would be required in such a takeout. The value of this required consideration, as I just pointed out, is in turn significantly lower than the bid's price. And note that the acquirer's valuation of minority shares cannot be significantly lower than the market's valuation; this must be the case since one thing that the acquirer could do with minority shares purchased in a takeout is sell them later on to public investors for a price equal to the value that these investors attach to such minority shares.33/

If minority shareholders could expect to receive their prorata share of the target's future stream of earnings, the value of their shares would be equal to that of shares in the bidder's controlling block. Why, then, do the acquirer and the market attach to minority shares a value lower than the bid's price? The primary reason is that the bidder's control over the target might enable the bidder to deny minority shareholders their prorata share of the target's future earnings, and to leave them with even less than the consideration which the bidder would have to pay them in an immediate takeout.

One way in which the acquirer might be able to take advantage of minority shareholders is by using its power to run the target's business in order to

---

33/ Suppose that the value of minority shares to public investors (assuming that they will be able to retain them at least for some given period of time) is $X per share. And suppose that the acquirer effects a takeout, and then offers the purchased shares to public investors, committing itself not to make another takeout within the given period of time. The acquirer will be able to charge public investors $X per share, thus netting $(X-t) per share where $t is the per share transaction costs involved in a public offering. Since such transaction costs are usually small relative to the price of the offered shares, it follows that the acquirer's valuation of minority shares (which is at least $(X-t) per share) cannot be significantly lower than the market's valuation of $X per share.

divert to itself part of the target's potential profits.[34/] For example, the acquirer might engage in self-dealing, transacting with the target on terms that favor the acquirer;[35/] or the acquirer might allocate to itself business opportunities which belong wholly or partly to the target.[36/] While such diversions of earnings might be unlawful, they are often quite possible due to the obvious problems involved in detecting and challenging them. The potential for such diversions is especially considerable when the acquirer and the target have similar or complementary lines of business, and this is frequently the case when either the acquirer or the target are conglomerates.

The other way in which the acquirer might be able to take advantage of minority shareholders is by effecting a takeout later on (a "distant takeout"). An acquirer which does not effect an immediate takeout presumably makes this decision keeping in mind, if not relying on, the possibility of a distant takeout. Postponing a takeout might benefit the acquirer in two ways. First, the acquirer might expect that by waiting it might benefit from inside information that will improve its ability to determine whether a takeout will prove profitable. This consideration might be especially important when there is a substantial uncertainty about the target's prospects. The acquirer might expect that in time it will get enough inside information to enable it to have an estimate of the target's prospects that is substantially better than the market's estimate. If the inside information suggests that the target's prospects are rosy, the acquirer will effect a takeout before the information

---

34/ See, e.g., Brudney, Efficient Markets and Fair Values in Parent Subsidiary Mergers, J. Corp. L. 63 (1978).

35/ See, e.g., Schlick v. Penn-Dixie Cement Corp. 507 F. 2d 374 (2d Cir. 1974); Sinclair Oil Corp. v. Levien, 280 A. 2d 717 (Del. 1971).

36/ See, e.g., Swanson v. American Consumer Indus. Inc., 415 F. 2d 1326 (7th Cir. 1969).

becomes reflected in the market price;[37/] and if the inside information is unfavorable, the acquirer will let minority shareholders retain their shares. In this way, the acquirer will fully expose minority shareholders to the down side of the target's uncertain prospects, but deny these shareholders the upward side.

Second, postponing the takeout might enable the acquirer to influence the size of the takeout consideration that minority shareholders' appraisal rights will require. As the Delaware Supreme Court noted, the timing of a takeout might be controlled by the acquirer "to favor the majority only, based upon the status of the market and the elements of an appraisal;"[38/] for example, as earnings and market price are common elements of appraisal, the acquirer might choose a time in which earnings are abnormally low, or in which market price is substantially lower than what the acquirer's inside information suggests.[39/] Furthermore, not only will the acquirer choose a time in which the appraisal's elements would be low in any event, but the acquirer might also further lower these elements at and before the time of the takeout; for example, the acquirer might depress the target's earnings in the period prior to the takeout, or it might depress the target's market price in that period by using its control over the target's dividend policy and over the release of information about

---

37/ While the law will require the acquirer to disclose all material information when proposing the takeout merger, this requirement can hardly preclude the concealment of such information, due to the ambiguity of the concept "material" information and to the difficulty involved in identifying the kind of knowledge concerning the future which must be disclosed and which management actually knows. See Brudney, supra note 34, at 71.

38/ Roland International Corp. v. Najjar 407 A. 2d 1032, 1037 (Del. 1979).

39/ See, e.g., Weinberger v. VOP, Inc. 457 A. 3d 701 (Del. 1983); Berkowitz v. Power/Mate Corp., 135 N.J. Super. 36, 342 A. 2d 566 (App. Div. 1975).

the target.[40/] Finally, it is worth noting that the shadow of a future takeout might depress the minority shares' market price, on which the appraisal formula is often based; even supposing that the informational efficiency of capital markets is perfect, the threat of the takeout possibility might lead the market to price minority shares at a considerable discount from the market's estimate of the shares' prorata fraction of the target's future earnings.[41/]

In sum, following a takeout an acquirer that seeks to take advantage of minority shareholders has available to it other means than effecting an immediate takeout. The recent SEC Advisory Committee on Tender Offers observed that as a matter of fact the post-takeover value of minority shares is higher in those instances where an immediate takeout takes place than in those where it does not;[42/] and a subsequent study by the SEC's Chief Economist confirmed this observation.[43/] The preceding analysis explains this empirical observation: those instances where an immediate takeout does not currently take place are exactly the instances where the acquirer expects to succeed, through diverting earnings or a distant takeout or both, to leave minority share-

---

40/ See, e.g., Marsh v. Armada Corp. 533 F. 2d 978 (6th Cir. 1976); Mutual Shares Corp. v. Genesco, Inc., 384 F. 2d 540 (2d Cir. 1967); Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66 (S.D.N.Y. 1969).

41/ The size of the discount depends on investors' expectations concerning the acquirer's strategy. Different discounts (or even no discount) are all consistent with investor rationality. Suppose, for example, that the per share value of the target's potential future earnings is $100. Suppose, however, that investors believe that the acquirer's strategy (to which the acquirer is fully committed) is to distribute no dividends until it will be able to effect a takeout at $50 a share. Then the value that investors will (rationally) attach to minority shares will be $50 a share and this will be immediately reflected in the market price. Of course, different expectations concerning the acquirer's strategy will lead to different discounts (or even no discount).

42/ See Advisory Committee Report, supra note 10, at 25.

43/ See SEC Release, supra note 11.

holders with even less than the consideration that the acquirer would have to pay them in an immediate takeout.[44/]

3. Minority Shares' Value v. The Bid's Price

The preceding analysis suggests that, under the current legal rules, the expected post-takeover value of minority shares is generally lower than the bid's price. This is the case, I have shown, both when the bidder is expected to effect an immediate takeout upon gaining control, and when the bidder is expected not to do so. It follows that this is also the case when there is uncertainty as to which one of these two possible courses of action the acquirer will take.

Finally, the above analysis is confirmed by the empirical evidence. A study by Professor Bradley indeed found that the post-takeover market price of minority shares is significantly lower than the bid's price.[45/] And a study by the SEC's Chief Economist (a study which was limited to partial bids) confirmed this finding.[46/]

B. The Acquisition Price in a Takeover

I should now like to clarify and discuss the concepts of "the (total) acquisition price" and "the per share acquisition price" in a takeover. These concepts appear in the definitions of both the undistorted choice objective

---

44/ While I accept the Advisory Committee's and the Chief Economist's empirical observation, I do not agree, see Section III.B, with their inference that prohibiting takeouts at less than the bid's price would hurt minority shareholders.

45/ See Bradley, supra note 8.

46/ See SEC Release, supra note 11.

and the unequal treatment objective. Undistorted choice requires, I said, that a target be taken over if and only if a majority of its shareholders view the offered total acquisition price (which reflects the value that the bidder attaches to the target's assets) as higher than the target's independent value. And a shareholder is unequally treated, I said, when he is denied his prorata share of the total acquisition price.

1. The Presence of Unacquired Shares

In a merger, the total acquisition price is obviously equal to the consideration paid for each of the target's shares multiplied by the number of the target's shares. Defining the acquisition price in a merger is simple because in a merger the acquirer purchases all of the target's shares. Defining the total or per share acquisition price in a takeover is more problematic, however, due to the general presence of unacquired shares. To be sure, a successful takeover bid involves (by definition) the acquisition of a controlling interest in the target. But the bidder generally does not acquire through its bid all of the target's shares, but rather less than that, and often considerably less.

There are two reasons for the general presence of unacquired shares in takeovers. The first reason is that some target shareholders do not tender their shares; even successful bids do not generally attract all of the target's shares. I shall explain later in this Part why, in spite of the expected low post-takeover value of minority shares, many shareholders do not tender their shares to bidders that turn out to be successful.[47/] As will be explained, non-tendering shareholders in successful bids roughly fall into three groups:

---

47/ See Section D of this Part.

first, those who did not tender because they lacked an opportunity to do so, because they were either unaware of the bid or unable to deliver their shares in time; second, those who did not tender because they viewed the independent target's per share value as higher than the bid's price and hoped that the bid would fail; and, third, those who did not tender for tax reasons. For now, let us only note that as a matter of fact there is currently a substantial and widespread incidence of non-tendering shareholders in successful bids: there is commonly a substantial fraction of the target's shareholders -- frequently twenty or thirty percent, or even more than that -- who did not tender their shares to the successful bidder.[48/]

The second reason for the presence of unacquired shares is that in many takeovers the acquirer does not purchase all of the tendered shares. There are two kinds of bids: "for all shares," and "partial." In a bid for all shares the offeror commits itself, at least in case the bid is successful, to purchase all tendered shares. In contrast, in a partial bid the offeror commits itself in no case to purchase more than a specified fraction (say, 51%) of the target's shares. At present most bids are partial.[49/] When a partial bid is oversubscribed, the acquirer may, and usually does, refuse to accept more shares than the number sought. In such a case, the Williams Act

---

48/ This is the picture arising from data collected by Professor Bradley of The University of Michigan Business School (personal communication between Professor Bradley and the author).

It might be worthwhile noting that even in U.S. Steel's takeover of Marathon Oil, where an immediate takeout at a price lower by dozens of dollars than the bid's price was expected, only 90% of Marathon's shareholders tendered. See Radol v. Thomas, 534 F.Supp. 1302, 1305 (S.D. Ohio 1982).

49/ See, e.g., Bradley, Desai, & Kim, "The Rationale Behind Interfirm Tender Offers," 11 J. Fin. Econ. (1983).

requires that shares be taken prorata, so that each tendering shareholder will have the same fraction of his shares rejected.[50/]

2. Defining the Acquisition Price

a. Actual Acquisition Price

It will be helpful to discuss the concept of a takeover's total acquisition price in the context of an example. Let us therefore consider the case of a target with 100 shares, and an offeror that gains control by acquiring through a takeover bid 70 shares (70% of all outstanding shares) for a bid's price of $100 a share. Only 70 shares are purchased for the bid's price either because only 70 shares were tendered, or because the bid was partial and limited to 70 shares. Let us also suppose that the post-takeover value of the remaining 30 minority shares is $80 a share.

It might be thought that the described takeover does not involve the acquisition of the target as a whole. All that the takeover involves, it might be argued, is the purchase of 70% of the target's shares for $100 a share, or a total price of $7,000. As explained below, however, this view is mistaken. The transaction should be viewed, I suggest, as one that is equivalent to acquiring the target as a whole, and it thus makes sense to talk about the total acquisition price involved.

The acquisition of a controlling interest in a target with a previously dispersed ownership is fundamentally different from a purchase of a non-controlling block. The acquisition of a non-controlling block, say 5% of the target's shares, usually affects only the parties to the transaction -- the buyer and the selling shareholders. Shares change hands, but the value of the whole

---

50/ *See* 15 U.S.C. § 78 (n)(d)(6)(1976).

enterprise, the way in which it is run, and the position of non-selling shareholders are unlikely to be affected.

In contrast, when a bidder acquires a controlling interest in a target, the enterprise's value, and the way in which it is run, might well change; and the position of non-selling shareholders is clearly affected.[51/] The takeover might affect the value of unacquired shares in substantial and varied ways. The takeover might reduce the value of unacquired shares by exposing them to the possibilities of a takeout and of the bidder's diversion of earnings, and by ruling out the possibility of future premium bids. And the takeover might also enhance the value of unacquired shares (vis-a-vis the pre-bid value) in various ways.[52/]

Thus, a minority share in the taken over target generally has a different value -- whether higher or lower -- than does a share in the independent target. The two are, as it were, different securities -- different assets, representing different future streams of earnings. The takeover thus transforms the nature and value of unacquired shares. The takeover brings out of existence the asset referred to as "a share in the independent target," and replaces it with another one -- "a minority share in the taken over target."

Returning to the considered example, the above discussion suggests that the takeover should not be viewed as involving only 70 shares. Rather, I

---

51/ "A change in control can result in what amounts to a new, or at least vastly changed, company." Address on Proposed Legislation to Regulate Tender Offers by Manuel Cohen, SEC Chairman, before the American Society of Corporate Secretaries, Inc. (Excerpted in V. Brudney & M. Chirelstein, Cases and Materials on Corporate Finance (2nd ed., 1979)).

52/ When the acquirer does not effect an immediate takeout, the takeover might enhance the value of unacquired shares by producing gains from improved management or from "synergy," gains which minority shareholders might partly share. And when the acquirer does effect an immediate takeout, it is possible that the value of the takeout consideration, though lower than the bid's price, will exceed the value of shares in the independent target.

suggest, the bidder should be viewed as having purchased all the 100 shares of the independent target; and as having paid for each of 70 shares with the bid's price of $100, and for each of 30 shares with a minority share worth $80. And the bidder should thus be regarded as having acquired the target for a total acquisition price of 70 x $100 + 30 x $80 = $9,400, or for a per share acquisition price of $94.

This picture of what has happened in the considered takeover is clearly accurate from the perspective of the target's shareholders. As a result of the takeover, the shareholders have lost all the 100 shares in the independent target that they held. Instead, they have ended up with the bid's consideration paid for 70 shares and with 30 minority shares.

This picture is also accurate from the bidder's perspective. The value of the minority shares -- $80 times 30 shares, or $2400 --represents the part of the target's future stream of earnings that (given the possibilities of a takeout and of a diversion of earnings) the minority shareholders can expect to capture. The acquirer, in turn, can expect to capture all of the target's value minus these $2400. Hence, the takeover is equivalent from the bidder's perspective to one in which it purchased all of the target's shares for a consideration of $9,400 and then sold to the shareholders minority shares worth $2400.

b. Expected Acquisition Price

Thus far we have been dealing with the actual acquisition price in case of a takeover. Let us now consider the acquisition price that was expected when the offeror made its bid and the shareholders made their tender decisions. The expected acquisition price is important because it reflects better than the actual acquisition price does the bidder's valuation of the target; and, as Part VI will explain, this valuation is relevant for the efficient allocation of the target's assets.

Let us therefore consider our example from the perspective of the point in time in which the offeror makes its bid. And let us suppose that at this point in time the estimate is that, should the bid be successful, the expected number of shares that the offeror will purchase for the bid's price is 70. It might be expected that only 70 shares will be tendered; or the bid might be partial and limited to 70 shares. In either case, I suggest, the expected acquisition price is $9,400 and the expected per share acquisition price is $94.

No one, I think, would dispute the above figures if the reason for the expected presence of unacquired shares is that the bid is partial and limited to 70 shares. But some might dispute the above calculation if the bid is for all shares. After all, they would argue, the offeror's bid will obligate it to pay $100 a share for all of the target's shares if all the shareholders tender, and it is only due to non-tendering by some shareholders that the target's shareholders might end up with a total acquisition price of less than $100 a share. The possibility of all of the shareholders tendering, however, is highly theoretical; the bidder is presumably well aware of the general presence of non-tendering shareholders in successful bids. And if, as is assumed in the considered example, the expected number of tendered shares in case of a takeover is 70, then it follows that the expected acquisition price which the bidder faces is $94 per share.

### 3. Conclusion and Comparison with the Bid's Price

To conclude, the actual acquisition price in a takeover is the sum of the bid's price multiplied by the number of the target's shares acquired through the bid, plus the post-takeover value of minority shares multiplied by the number of such shares. The expected acquisition price is similarly defined, except that its definition uses the expected values, rather than the actual ones, of minority shares' post-takeover value and of the numbers of acquired and unacquired shares. While the actual acquisition price in a takeover might differ from the expected acquisition price, I shall most of the time not attempt to distinguish between the two, and shall refer to both as the acquisition price.53/

The post-takeover value of minority shares, we have seen, is lower than the bid's price. Consequently, since it is generally the case in takeovers that some of the target's shares are not acquired for the bid's price, the per share acquisition price is generally lower than the bid's price. The larger the fraction of unacquired shares, and the greater the gap between the bid's price and the post-takeover value of minority shares, then the greater the gap between the bid's price and the per share acquisition price.

The gap between the bid's price and the per share acquisition price is probably greater on average in successful partial bids than in successful bids for all shares. For whenever a partial bid is oversubscribed, which frequently happens, the fraction of unacquired shares is greater than it would be if the bid were for all shares. But it should be emphasized that, given the general substantial presence of non-tendering shareholders, a significant gap does usually exists in successful bids for all shares, even though this gap might be smaller on average than the one present in successful partial bids.

---

53/ In referring to the acquisition price, I shall usually be referring to the expected acquisition price in the context of the distorted choice issue, and to the actual acquisition price in the context of the unequal treatment issue. And it will be clear to the reader from the context which of the two possible meanings I shall be referring to.

## C. The Current Distorted Choice

I now turn to describe how the outcome of takeover bids is currently distorted. It is worth emphasizing that by referring to a bid's outcome, and to the shareholders' tender decisions leading to it, as distorted, I do not wish to imply that these decisions are involuntary or illegitimately forced. Rather, the outcome, and the tender decisions leading to it, are distorted in the sense that they deviate from the proposed benchmark of social desirability -- the baseline suggested by the undistorted choice objective.

As will be demonstrated below, at present a target might well be taken over even if a majority of its shareholders view the expected acquisition price as lower than the independent target's value. The main reason for this distorted choice, and the one on which I shall focus, is that shareholders might well tender their shares even if they view the expected acquisition price as lower than the target's independent value. The second reason, with which I shall start, is that the bidder might gain effective control even if less than a majority of the shareholders tender their shares.

### 1. The Problem of Effective Control Without Majority Ownership

The main source of the current distortions, as I have just said, is that shareholders' tender decisions do not reflect their judgment as to whether or not the expected acquisition price exceeds the independent target's value. Suppose for a moment, however, that shareholders do tender their shares if and only if they view the acquisition price as higher than the independent target's value. In this case, a bid's ability to attract a majority of the target's shares would imply that a majority of the shareholders view the bid's acceptance as value-maximizing. Consequently, if the acquisition of a majority interest were a necessary and sufficient condition for a takeover, the undistorted choice objective would be attained.

Now, a majority interest is generally sufficient for controlling the target. A majority interest will generally enable the acquirer to elect the target's directors, and to effect a merger between the target and itself, even if all other shareholders vote, and vote against the acquirer.[54/] Thus, the bidder will be able to take advantage of minority shareholders by effecting a takeout (immediately or later on) or by diverting the target's earnings to itself. While majority ownership is generally a sufficient condition for control, however, it is generally not a necessary condition. When the ownership of the target is substantially divided, a bidder might well gain effective control by purchasing a substantial block, say 40%, which falls short of a majority interest. Such a block will usually enable the bidder to control the election of directors, and to lead to a merger.[55/]

Thus, a bidder might gain control over a target by purchasing less than a majority interest. As I have explained, a bidder that acquires such a controlling interest will be able to take advantage of other shareholders, either by effecting a takeout at terms favorable to itself or by diverting the target's earnings to itself. Consequently, the post-takeover value of outstanding shares will be lower than the bid's price. I shall refer throughout to such outstanding shares as "minority shares," even though at times (when the bidder's controlling interest is less than a majority) it might be more accurate to refer to them as "a powerless majority."

Thus, even supposing that shareholders tender their shares if and only if they view the offered acquisition price as higher than the independent target's value, the current outcome of takeover bids might still be distorted. Consider,

---

54/ *See* the discussion in *supra* note 24.

55/ *See* Brudney, *supra* note 34.

for example, a case in which 40% of the shareholders view the offered acquisition price as higher than the independent target's value, while 60% hold the contrary view. According to the undistorted choice objective, it is desirable that the considered bid will fail. But if 40% of the shareholders tender, as we suppose they will, the target will be taken over.

The problem of bidders' ability to gain control without attracting a majority of shares, then, is by itself sufficient to distort bids' outcomes. By itself, however, this problem is one which would not be difficult to address. This could be done by prohibiting bidders from acquiring a controlling interest unless their bid has attracted tenders from a majority of the shareholders. Supposing that tender decisions reflect shareholders' judgments as to whether the acquisition price exceeds the independent target's value, this measure would be sufficient to ensure undistorted choice. Therefore, let us now put aside the problem of effective control, and focus on a more difficult problem: the fact that shareholders' current tender decisions might well deviate from what is suggested by the undistorted choice objective.

## 2. Target Shareholders' Tender Decisions

### a. Shareholders' Undistorted Tender Decisions

The undistorted choice objective suggests that shareholders should tender their shares if and only if they view the expected acquisition price as higher than the independent target's value. That is, a shareholder's tender decision should be determined by his judgment as to how the above two values compare. If the shareholder owned all of the target's shares, he would accept an acquisition offer if and only if he viewed the acquisition price as higher than the independent target's value; and, according to the undistorted choice objective, the shareholder should tender if and only if he would as the target's sole owner sell the target for the bid's expected acquisition price.

By a shareholder's estimate of the independent target's value I mean his estimate of the value that the target would have if he could determine the bid's fate and if he used this power to order that the target remain independent (at least for the time being). Shareholders might of course differ in their estimates of the independent target's value, as the independent target's value depends on various imperfectly known factors: the future profitability of the target in a continued independent existence, and the prospects of receiving other acquisition offers in the future.

For the purpose of defining a given shareholder's undistorted tender decision, the relevant estimate of the independent target's value is the one that the shareholder has when he makes his tender decision -- that is, the estimate that he can make on the basis of the information that he has at that time. Note that at that time the shareholder has less than perfect information about the estimates of other shareholders, who might have information that he does not possess concerning the independent target's value. Consequently, the shareholder's estimate might be different from the one that he would make subject to an assumption that exactly X percent of the target's shareholders are going to tender. That is, the shareholder's estimate might be different from an estimate conditional on the fact that X percent of the shareholders will tender. The reason for this is that the shareholder might infer from the fact that exactly X percent are going to tender some information concerning other shareholders' estimates of the independent target's value; and this information might lead him to revise his own estimate.[55a/]

---

55a/ As will be seen, this issue is quite relevant for designing measures to attain undistorted choice. In particular, it will be shown that due to this issue a certain (seemingly promising) approach -- eliminating the gap between the bid's price and the expected post-takeover of minority shares -- would not attain undistorted choice. See Part IV, Subsection B.3.

b. Shareholders' Actual Considerations

Let us now turn to examine the considerations that shape a given shareholder's actual tender decision. As will be seen, these considerations have little to do with whether or not the shareholder views the expected acquisition price as higher than the independent target's value.

In making his tender decision, a given shareholder will presumably realize that the expected effect of his decision on the bid's success is very small, if not negligible. This is true not only for small shareholders, but also for relatively large ones who hold, say, one percent of the target's stock. First, in the spectrum from a small non-controlling block to a majority block there is no point where the purchase of an additional one percent of the target's shares would significantly change the amount of control that the block's owner has. Consequently, the amount of control that the bidder will obtain in case the given shareholder tenders will not be significantly different from the amount of control that the bidder will obtain in case the shareholder holds out. Second, even if there were some magic threshold of ownership the mere crossing of which would significantly matter (if, for example, a majority interest were not only sufficient but also absolutely necessary for control), the likelihood that the shareholder's decision will prove pivotal would still be very small.

Thus, in the shareholder's considerations, the possibility that his decision will affect the bid's success will be ignored or at least dominated by the possibility that his decision will have no effect on the bid's fate. Consequently, the shareholder will mainly consider two possible cases: the bidder might succeed in gaining control, or the bidder might fail to do so.56/

---

56/ There are obviously intermediate cases, where the bidder gains partial control. The conclusions of the analysis below would not be significantly affected if such cases were to be incorporated.

And for each of these two possible cases, the shareholder will examine whether he will be better off tendering or holding out.

Consider first the case in which the bid succeeds and a takeover takes place. In this case, if the shareholder holds out, all of his shares will become minority shares with a post-takeover value lower than the bid's price. On the other hand, if the shareholder tenders, he will have all of his shares -- or, in case of a partial and oversubscribed bid, a major fraction of them -- acquired for the bid's price. In comparison to holding out, then, tendering will produce a gain for each tendered share that the bidder will acquire. Thus, <u>in case the bid is going to succeed, the shareholder will be better off tendering no matter how high his estimate of the independent target's value</u>.[57/]

Consider now the case in which the bidder fails to gain control and the target remains independent. Now, as bidders usually retain the option not to purchase tendered shares in case they fail to gain control, a failing bidder might proceed in two ways: it might return tendered shares to the tenderors, or it might elect to purchase these shares and thus obtain a possibly substantial (though non-controlling) block of the target's shares.[58/] If the failing

---

57/ As will be explained, some shareholders might prefer retaining minority shares in the taken over target to selling their shares for the bid's price. They might have such a preference due to their special tax circumstances: retaining minority shares -- and accepting a lower pre-tax wealth -- will reduce their tax liability. <u>See</u> Section D of this Part. In examining the actual tender considerations of a representative shareholder, I assume that the shareholder does not have such special tax circumstances.

58/ The reason as to why the failing bidder might wish to acquire a non-controlling block is that it might entertain the possibility of making another bid in the future, or that it might view the target's stock as a good investment (possibly due to the prospect of a future offer by another bidder). The failing bidder might choose to purchase tendered shares even if the bid's price exceeds the market price of the independent target's shares following the bid's failure; for an attempt to purchase a substantial block in the market might drive the market price above the bid's price.

The reason as to why the bidder might elect to return tendered shares is that it has decided to "give up" the idea of taking over the target and that it does not wish to invest its (possibly quite limited) funds in a non-controlling block.

bidder returns tendered shares, the shareholder's decision will make no difference: whether he tenders or holds out, he will end up with shares in the independent target. If the failing bidder elects to purchase tendered shares, however, the shareholder's decision will matter: if he holds out he will end up with shares in the independent target, while if he tenders he will have his shares acquired for the bid's price. Thus, <u>in case the bid fails</u>, and supposing that there is some likelihood that the failing bidder will elect to purchase tendered shares, <u>the shareholder will be better off tendering if and only if the bid's price exceeds his estimate of the expected value of the independent target's per share value in this case</u>.

Thus, while the shareholder will presumably wish to have his shares acquired in case of a takeover, he might or might not wish to have his shares acquired in case the target remains independent. Note, however, that currently shareholders cannot limit their tender to one of the two possible cases; they cannot, for example have their shares considered as tendered in case of a takeover but not otherwise. Shareholders at present can only choose between tendering and holding out: tendering enables the bidder to purchase their shares whether the bid succeeds or fails; and holding out leads to the bidder's not purchasing any of their shares in both possible cases.

What, then, will the shareholder elect to do? As just noted, he would like to have his shares acquired in case the bid succeeds. Consequently, if the shareholder concludes that he will wish to have his shares acquired for the bid's price even in case that the bid fails, he will certainly tender. If, however, the shareholder concludes that he would like to retain his shares in case the bid fails, he will have to weigh the costs and benefits of tendering. To this end, he will compare the probability of the bid's success with that of the bid's failure, and the expected gain from tendering in case that the bid succeeds with the expected loss from tendering in case that the bid fails. And in assessing the probabilities of the bid's success and the bid's failure, the shareholder will use whatever information he has both about other shareholders' estimates of the independent target's value <u>and</u> about the set of beliefs other shareholders have concerning others' estimates and beliefs.

c. <u>The Nature of Shareholders' Actual Considerations</u>

The above analysis suggests that the considerations which actually shape a shareholder's tender decision are <u>quite different</u> from those that according to the undistorted choice objective should determine this decision. I wish now to draw attention to, and highlight, this crucial difference.

As explained above, the shareholder will be examining for each of the two possible cases whether he will be better off tendering or holding out. Consider first the case in which the bid is going to succeed. The shareholder's best course of action in this case will be determined by the general expectation that the post-takeover value of minority shares will be lower than the bid's price. Consequently, in case the bid is going to succeed, the shareholder will be better off tendering no matter how high his estimate of the independent target's value. Thus, the prospect of a takeover introduces a pressure on the shareholder to tender his shares regardless of what is suggested by the undistorted choice objective. The greater the likelihood that the shareholder attaches to a takeover, and the larger the gap between the bid's price and the expected post-takeover value of minority shares, then the stronger the pressure to tender. But as long as there is some likelihood of a takeover, a pressure to tender does exist.

The described pressure to tender, I wish to emphasize, is present whether the bid is partial or for all shares, and whether or not a takeover is expected to be followed by an immediate takeout. This is worth emphasizing because many seem to believe that to the extent that any choice distortions exist, they are rooted in the practices of partial bids and immediate takeouts.[59] As has been seen, however, a pressure to tender results from the presence of a gap between the bid's price and the expected post-takeover value of minority shares, and such a gap is generally present in all bids.

Examine now the considerations that determine the shareholder's best course of action in case that the bid is going to fail. Again, this course of action might well differ from the one that is suggested by the undistorted choice objective. The shareholder's best course of action in case the bid fails depends on how the bid's price compares with the value that the independent target's shares are expected to have in this case. This comparison is different in two ways from comparing (as the undistorted choice suggests) the expected acquisition price with the shareholder's estimate of the independent target's value. First, the shareholder will be taking into account not the expected per share acquisition price but rather the bid's price; and the latter is generally higher than the former. Second, the shareholder will be taking into account not his (unconditional) estimate of the independent target's value but rather an estimate which is conditional on enough shareholders resisting the pressure to tender for the bid to fail; and the latter estimate is generally different, and probably higher, than the former.

In sum, the considerations that actually determine shareholders' tender decisions have little to do, if anything, with whether or not the shareholders view the expected acquisition price as exceeding the independent target's value. It still remains, however, to determine the direction of the current distortions, and it is to this question that I now turn.

---

59/ See Part IV, Section A.

3. The Direction of the Current Distortions

The analysis of how many of a target's shareholders will tender -- given a particular distribution of the shareholders' estimates of the independent target's value -- is a complex one. And it will often be impossible to predict with absolute certainty what a bid's outcome will be. For one thing, shareholders' tender decisions might well depend on the probabilities that each of them attaches to the bid's success and to the bid's failure; and these probabilities depend not only on shareholders' estimates of the independent target's value, but also on their beliefs concerning the distribution of estimates, on their beliefs concerning others' beliefs concerning the distribution of estimates, and so forth.60/

While it might often be impossible to predict with certainty a bid's outcome, it is nonetheless possible to identify a clear and strong direction in which the current distortions operate. In comparison to the benchmark established by the undistorted choice objective, the current distortions operate systematically in bidders' favor. At present, a bid is highly likely to succeed when a majority of the target's shareholders view the expected acquisition price as higher than the independent target's value, and it might well succeed even if that is not the case.

To see the direction of the current distortions, let us study the expected outcome of bids under the simplifying assumption that all the shareholders of a target share the same estimate of the independent target's value, and that each of them knows that all the others share his estimate. As it will be useful to study the issue in the context of an example, suppose that the

---

60/ Indeed, as will be seen below, even with a complete specification of shareholders' estimates and beliefs concerning others' information, different outcomes might be possible (or, in the jargon of economics, the equilibrium might not be unique).

shareholders of a target face a $100 a share bid (which might be partial or for all shares), with an expected post-takeover value of minority shares of $80 a share; and suppose that the shareholders' common estimate of the independent target's value is $I a share.

Suppose first that $I, the shareholders' common estimate, is lower than the $100 bid's price. In this case, any given shareholder will tender his shares. For, given the value of $I, he will wish to have his shares acquired for the bid's price both in case the bid succeeds and in case it fails: a given shareholder will wish to have his shares acquired in case of a takeover no matter how high $I is; and, as $I is lower than the $100 bid's price, the shareholder will also wish to have his shares acquired in case the bid fails.61/

Thus, whenever $I is lower than the $100 bid's price, the target will be taken over. Note that this suggests by itself that bids' outcomes are currently distorted in bidders' favor. For the undistorted choice objective requires that the target will be taken over only if $I is lower than the expected per share acquisition price. And, as I have explained, the expected per share acquisition price is generally lower than the bid's price, in both partial bids and bids for all shares.

Suppose, for example, that the bid in the considered example is partial and that in case of a takeover the bidder is expected to purchase 50% of the target's shares for the $100 bid's price. In this case, the expected per share acquisition price is $90: hence, according to the undistorted choice objective, the target should be taken over only if $I is lower than $90. As

---

61/ To be sure, the shareholder will attach a zero probability to the bid's failure. But supposing theoretically that the target remains independent, the shareholder expects the market price of its shares to be $I; and since $I is lower than the $100 bid's price, the shareholder will wish to have his shares acquired for the bid's price.

we have just seen, however, as long as \$I is lower than \$100, the target will certainly be taken over.[62/]

Suppose now that \$I, the shareholders' common estimate of the independent target's per share value, exceeds the \$100 bid's price. In this case, the target might or might not be taken over. A given shareholder will still wish, as always, to have his shares acquired in case of a takeover. But he will now wish to retain his shares in case the target remains independent, as he expects that in such a case the independent target's share value will exceed \$100. Consequently, a given shareholder might or might not tender. The greater the probability that he attaches to a takeover, and the greater the gap between the bid's price and the expected post-takeover value of minority shares (\$20 is the considered example), then the greater the likelihood that the shareholder will tender. Similarly, the greater the probability that he attaches to the bid's failure, and the larger the gap between \$I and the \$100 bid's price, then the greater the likelihood that the shareholder will hold out.

It might be asked why a shareholder would attach any likelihood to the possibility of a takeover even though he knows that he as well as all other shareholders estimate the independent target's per share value to be higher than the bid's price. There are two reasons as to why a rational shareholder might do so. First, while we assume that the shareholder knows with certainty that other shareholders' estimates are uniform and equal to his own, he might be uncertain as to what other shareholders' beliefs are. He might be unsure,

---

62/ Or suppose that the bid in the considered example is for all shares, and that the expected fraction of non-tendering shareholders (say, shareholders who lack an opportunity to tender) is 20%. In this case, the expected per share acquisition price is \$96. Hence, according to the undistorted choice objective, the target should be taken over only if \$I is lower than \$96. Thus, if \$I is between \$96 and \$100, a distorted outcome will surely take place, as the target will certainly be taken over.

for example, as to whether all other shareholders are certain that the distribution of estimates is uniform (as indeed it is), or he might be unsure as to whether all other shareholders are certain that all other shareholders are certain that the distribution of estimates is uniform, and so forth. And any uncertainty of this kind might lead the rational shareholder to attach a positive likelihood to the possibility of a takeover.[63/]

Second, and more importantly, even supposing no shareholders face any uncertainty of the above kind, a rational shareholder might still ascribe a significant likelihood to the possibility of a takeover. To be sure, if the shareholders could coordinate their actions, then they would all conclude an agreement to hold out their shares, and a rational shareholder would view a failure of the bid as certain. But the shareholders presumably cannot conclude such an agreement. Consequently, a given shareholder has to make his tender decision without assurance as to how the others will act. Of course, his decision will depend on his expectations concerning the others' actions, expectations that he will form with the recognition that others reason in a similar fashion. In such a situation, it would be perfectly rational for some, many, or indeed most shareholders to attach a significant likelihood to the possibility of a takeover. For such initial expectations on their part might well be self-fulfilling: they could lead to tenders in a sufficient number for the bidder to gain control. To be sure, it is possible that all or

---

63/ The described reason for viewing a takeover as possible will not exist only if the uniformity of shareholders' estimates is what economists call "common knowledge". For the considered piece of information to be "common knowledge" is a very strong requirement. Shareholders must all know about the uniformity, must all know that all the shareholders know about the uniformity, must all know that all the shareholders know that all the shareholders know about the uniformity, and so forth, ad infinitum. On the concept of "common knowledge," <u>see</u> Auman, Agreeing to Disagree, 4 <u>The Annals of Statistics</u> 1236 (1976).

most of the shareholders would adopt initial expectations that the bid would fail; such expectations might again be self-fulfilling. Thus, rational shareholders' initial expectations can go both ways; and, as the prevailing initial expectations are likely to be self-fulfilling, so can the bid's outcome.[64/]

The conclusions of the above analysis (which used the simplifying assumption that all shareholders have the same estimate of the independent target's value) might be thus summarized as follows. Whenever the shareholders' estimate is lower than the expected per share acquisition price -- that is, whenever a takeover is socially desirable -- then the bid will indeed succeed. When the shareholders' estimate is higher than the expected per share acquisition price, however, the target might still be taken over. First, as long as the shareholders' estimate is lower than the bid's price, the target will be surely taken over. Second, even if the shareholders' estimate is higher than the bid's price, the bid might still succeed if enough shareholders are sufficiently concerned about the possibility of a takeover. The bid will likely fail only if (i) the shareholders' estimate of the independent target's per share value is higher not only than the expected per share acquisition price but also than the bid's price, and (ii) there is a widespread confidence that the bid will fail (say, because the offered acquisition price is generally perceived as ludicrously low). In sum, the above analysis suggests that the current distortions operate systematically and substantially in bidders' favor.

---

64/ In the language of economics, even if the uniformity of the shareholders' high estimates of the target's value is "common knowledge," the equilibrium is not unique: both the bid's failure and the bid's success are a possible rational expectations equilibrium.

4. The Current Distortions and Market Trading

I wish now to respond to an objection that is likely to be made against the preceding analysis of the current distortions. The objection is based on the fact that when a bid is made the target's shareholders can (and often do) sell their shares in the market in the period between the making of the bid and its expiration. Indeed, there is commonly a very active trading in the target's shares in that period -- usually with a heavy participation by arbitrageurs.65/

It will be useful to describe the considered objection in the context of an example. Recall therefore the example of a $100 a share bid, where the expected post-takeover value of minority shares is $80, and where all the shareholders have the same $I estimate of the independent target's per share value. I have suggested that the considered bid might succeed ~~even~~ if the shareholders' common estimate $I exceeds the $100 bid's price. The objection that I wish to consider disputes this claim, and it runs roughly as follows. My analysis, it is objected, considered only two alternatives that shareholders face -- tendering, and retaining one's shares beyond the bid's expiration. But shareholders have a third alternative: selling their shares in the market. The market price of the target's shares, so the argument goes, will reflect the shareholders' common estimate $I of the independent target's per share value. If I exceeds the $100 bid's price, then the market price of the target's shares will equal $I and hence will exceed the bid's price; consequently, no shareholder will tender, as tendering will be clearly inferior to selling one's shares into the market.

The considered objection, then, suggests that the existence of market trading in the target's shares will ensure that it will not be taken over if

---

65/ See generally Henry, Activities of Arbitraguers in Tender Offers, 119 U. Penn. L. Rev. 466 (1971); Rubin, Arbitrage, 32 Bus. Law. 1315(1977).

all or most shareholders view the independent target's per share value as higher than the bid's price. Conversely, it is suggested that if the market price of the target's shares prior to the expiration of a successful bid was lower than the bid's price, the market price should be viewed as an indication that most of the shareholders did view the independent target's per share value as lower than the bid's price.

Note that even if the considered objection were valid, it would not imply that bids' outcomes are not distorted in bidders' favor, but only that the distortions are more limited than I suggest. For the objection is limited to my claim that the bid in the considered example might succeed even if $I exceeds $100. The objection does not dispute my claim that if $I is lower than the $100 bid's price, the bid will surely succeed. And, as I have explained, this claim implies by itself the existence of a substantial distortion in bidders' favor; for the undistorted choice objective requires that the bid will succeed only if $I is lower than the expected per share acquisition price, which is lower than the $100 bid's price.

In any event, the considered objection is not valid. While the identity of the target's shareholders might change between the bid's announcement and the bid's expiration, eventually the target's shareholders will have to choose between tendering and retaining their shares beyond the offer's expiration. To see the import of this fact, let us look closely at what might be referred to as "the moment of truth": the point in time just before the offer's expiration. No matter how many hands the target's shares have changed since the bid's announcement, at the moment of truth they are all necessarily owned by someone. In this moment of truth, the shares' ultimate owners face only two alternatives: tendering their shares to the bidder, or retaining their shares beyond the offer's expiration. Thus, my analysis of shareholder choice is perfectly applicable to the decisions of these ultimate shareholders at the moment of truth. They might tender even if at moment of truth they estimate the independent target's per share value to be higher than the bid's price; for they might be pressured to tender by the concern that in case they hold out a takeover might still take place.

Because shareholders are expected to be subject to a pressure to tender at the ultimate moment of truth, this looming pressure affects the market price in the period between the bid's announcement and the moment of truth. Investors who buy the target's shares in this period are aware that they (or, if they resell the shares, those who will buy the shares from them) will be ultimately subject to a pressure to tender; and the price that buyers will be willing to pay for the target's shares will inevitably reflect this awareness. In calculating the price that they are willing to pay for the target's shares, arbitrageurs and other potential buyers usually assume that, due to the current distortions of shareholder choice, the bid is likely to succeed, unless it is superseded by a higher competing bid or impeded by managerial obstructing tactics or governmental action. Consequently, the market price in the period during which the offer is open need not reflect shareholders' estimates of the independent target's value. In particular, this market price might be lower than the bid's price even if most shareholders view the independent target's per share value as exceeding the bid's price.

To be sure, the market's price of a target's shares does sometimes exceed the bid's price. This happens when (i) the present bid is expected to be superseded by a higher bid, or (ii) there is a widespread confidence that the target will remain independent, and that the value of the independent target's shares will exceed the bid's price. In these cases, however, an analysis ignoring market trading does suggest that the present bid will fail. Hence, the high market price in these cases only reflects -- rather than brings about -- the bid's expected failure.

In sum, the presence of market trading does little, if anything, to diminish the current distortions. The market price during the period in which an offer is open will reflect also the looming pressure to tender, and not only the shareholders' estimates of the independent target's value. Conversely, when a target is taken over, the fact that during the considered period the target's market price was lower than the bid's price should not be viewed as an indication that most of the shareholders viewed the independent target's per share value as lower than the bid's price.

5. The Current Distortions and Coordination Costs

We have seen that shareholders' tender decisions are currently distorted, and that the distortions operate systematically in bidders' favor. I wish now to examine the extent to which these distortions result from, or are related to, shareholders' inability to coordinate their actions. This examination will be helpful to the following Subsection's classification of the current distortions' sources, a classification which is the first step towards addressing these distortions.66/

As will be seen, some distorted outcomes would be avoided if shareholders could coordinate their responses to the bid. This is the case when the tendering shareholders prefer the target to remain independent but tender out of concern that others are going to tender; if coordination were possible, these

---

66/ Previous discussions of the distorted choice problem generally suggested that the current distortions are all attributable to shareholders' inability to coordinate their actions. See, e.g., Carney, supra note 7. As will be seen, below, however, only some, and not all, of the current distortions can be attributed to shareholders' inability to cooperate.

shareholders would conclude an agreement among themselves to hold out. Some distorted outcomes, however, would not be avoided if shareholders had the ability to cooperate. This is the case when tendering shareholders prefer the bid to succeed even though they judge the expected acquisition price as lower than the independent target's value; the reason why shareholders with such a judgment might prefer the bid to succeed is their expectation that in a case of a takeover they will receive more than their prorata share of the acquisition price (at the expense of non-tendering shareholders).

Again, it will be useful to discuss the issue in the context of an example. Consider the already used example of a \$100 a share bid for 60% of the target's shares, with a \$80 expected post-takeover value of minority shares; hence, assuming that the fraction of shares that the bidder is expected to purchase for the bid's price in case of a takeover is 60%, the expected per share acquisition price is \$92. As before, suppose that all shareholders have the same \$I estimate of the independent target's per share value. Let us add, however, a new fact: 20% of the target's shareholders are unaware of the bid (or unable to deliver their shares in time); thus, in case of a takeover, the fraction of non-tendering shareholders will be at least 20%.[67/]

Now, according to the undistorted choice objective the target should remain independent if \$I, the shareholders' common estimate of the independent target's value, exceeds the \$92 expected per share acquisition price. As I have explained, however, as long as \$I is lower than \$100, all shareholders who have an opportunity to tender will do so, and the target will certainly be taken over; and even if \$I exceeds \$100, the target might still be taken over.

---

67/ As will be seen (Section D of this Part), unawareness of the bid is only one reason among several for the presence of non-tendering shareholders in successful bids. For the purposes of the present analysis, what is important is that, whatever the reason, not all shareholders are expected to tender in case of a takeover.

Thus, a distorted outcome might well take place. An examination of this possible distorted outcome reveals that one could distinguish between two cases: one where cooperation among shareholders would not prevent a distorted outcome, and one where it would.

a. Distorted Choice that Would not be Avoided if Coordination were Possible

Suppose first that $I exceeds the $92 expected per share acquisition price but is lower than $95. In this case, as $I is lower than the $100 bid's price, all the shareholders who are aware of the bid and able to tender will do so, and a takeover will certainly take place. This distorted outcome, I wish to point out, would not be avoided if the target's dispersed shareholders had the ability to coordinate their actions.

The reason for this is that, due to the expected presence of non-tendering shareholders, tendering shareholders will correctly expect to be made better off by a takeover. Since 20% of the shareholders will not tender, the takeover's proration ratio will be 75%, and the takeover will hence leave tendering shareholders with an average per share value of $95. Consequently, as $I is lower than $95, tendering shareholders will prefer a takeover to take place.68/ To be sure, the takeover will make non-tendering shareholders worse off; they will have all their shares turn into minority shares worth $80 a share, which is substantially lower than $I. Indeed, the fact that $I is higher than the $92 per share acquisition price implies that the losses which the takeover will impose on non-tendering shareholders will exceed the gains that it will confer on tendering shareholders. While the tendering shareholders

68/ I assume that the likelihood of the bidder purchasing shares in case the bid fails is small. This assumption is reasonable as the $100 bid's price substantially exceeds $I, which will be the market price of the target's shares in case that the bid fails.

realize that the takeover will reduce the wealth of the target's shareholders as a group, they prefer the takeover to take place because it will enhance their own wealth. Consequently, even if the tendering shareholders could coordinate their responses, they would not conclude an agreement to uniformly hold out -- they would all still elect to tender, and the distorted outcome would still take place.

The reason as to why the tendering shareholders do prefer the takeover to take place is of course one that is irrelevant to the question whether or not the takeover is socially desirable. The tendering shareholders prefer the takeover only because they expect to receive more than their prorata share of the acquisition price. If the acquisition price were expected to be divided prorata (that is, if they were expected to end up with an average per share value of $92), they would prefer the bid to fail. The takeover is expected to transfer wealth from non-tendering shareholders to tendering shareholders, and it is only for this reason that the latter shareholders prefer a takeover; as earnings distributed by the independent target are distributed prorata, such a wealth transfer will not take place as long as the target remains independent.

The general lesson to draw from the above analysis is the following. At present, tendering shareholders can generally expect to receive in case of a takeover more than their prorata share of the acquisition price, and hence to end up with a higher per share value than the per share acquisition price. Consequently, there might be a difference between the judgment of tendering shareholders concerning whether or not they will be made better off by a takeover, and their judgment concerning whether or not the expected acquisition price exceeds the independent target's value. In particular, whenever tendering shareholders estimate the independent target's per share value to be higher than (i) the expected per share acquisition price, but lower than

(ii) the per share value with which they are expected to end up in case of a takeover, they would prefer a takeover to take place even though they expect it to reduce the total wealth of the target's shareholders. A situation of this kind is currently possible in all bids, whether partial or for all shares.[69/] Thus, to completely eliminate the current distortions, it will not be sufficient to ensure that shareholders do not tender unless they prefer the target to be taken over. It will be also necessary to address the possibility that tendering shareholders will prefer a takeover only because they expect to receive more than their prorata share of the acquisition price.

b. Distorted Choice that Would be Avoided if Coordination were Possible

Suppose now that \$I is higher not only than the \$92 expected per share acquisition price but also than \$95 (the average per share value with which tendering shareholders will end up if all the shareholders who can tender do so). The undistorted choice objective requires of course that the bid fail. But, again, a distorted outcome -- a takeover -- is possible. In the present case, however, a takeover will make worse off not only non-tendering shareholders but also tendering ones. Consequently, if the target's dispersed shareholders could coordinate their responses, all the shareholders who can tender would conclude an agreement not to do so, and a takeover would be avoided.

---

69/ To see how such a situation arises in the context of a bid for all shares, let us suppose that the \$100 bid in the considered example is for all shares. As 20% of the shareholders are assumed to lack an opportunity to tender, the per share acquisition price in case all other shareholders tender will be \$96. But tendering shareholders will end up in case of a takeover with \$100 per share. Thus, when \$I is between \$96 and \$100, the distorted outcome -- the takeover -- that will take place will be one that would not be avoided if the tendering shareholders had the ability to coordinate their actions.

Thus, in the present case (where $I exceeds $95) a distorted outcome would be avoided if the target's shareholders had the ability, which they generally lack, to act cooperatively. The possibility of a distorted outcome in the present case can be therefore attributed to shareholders' inability to cooperate.

It might also be useful to further divide the present case by introducing a distinction between two possible situations: one equivalent to, and one different from, the well known "prisoner's dilemma" situation.[70/] A "prisoner's dilemma" situation is one in which a group of parties (who are unable to cooperate) must each choose between two possible actions, say A and B. If they all choose A they will all be better off than if they all choose B. The problem, however, is that given any choice of action by the other parties, each party will be better off choosing B. Consequently, the rational decision for each party is to choose B. Thus, the prisoner's dilemma situation is one in which rational decisions by the parties are <u>bound</u> to lead to an outcome (everybody choosing B) which is worse for each of them than an outcome which they could attain (everybody choosing A).

Now, if $I is between $95 and $100, the situation of the target's shareholders (those who are able to tender) is equivalent to the prisoner's dilemma. The shareholders will all be better off if they all hold out than if they all tender. And whatever the other shareholders do, each shareholder will be better off tendering than holding out. Consequently, they will all tender, and the outcome which is inferior for each of them is bound to take place.

---

70/ On the prisoner's dilema *see generally* A. Rapport & A. Chammah, *Prisoner's Dilemma* (1965). It is worthwhile pointing out that the shareholders' predicament might or might not be equivalent to the prisoner's dilemma because some commentators thought that the former is always the case. *See, e.g.*, Lowenstein, *supra* note 5, at 307.

However, if \$I exceeds \$100, the shareholders' situation is somewhat different from the prisoner's dilemma. In this case, rationality need not always drive the shareholders to the collectively inferior outcome. A given shareholder will prefer to tender if the others do so, but will prefer to hold out if the others act similarly. Consequently, as I explained, shareholders' decisions very much depend on their expectations, and might go both ways. Consequently, a takeover -- the collectively inferior outcome -- might or might not take place.

## 6. The Current Distortions: Summary and Classification

The above analysis has demonstrated that bids' outcomes might be currently distorted: a target might well be taken over even if a majority of its shareholders view the expected acquisition price as lower than the independent target's value. I now wish to propose a classification of the current distortions. The proposed classification is only one of several alternative ways of looking at and classifying the current distortions; but it is one that will prove useful in designing a remedy to ensure undistorted choice.

If the following two conditions held, then they would ensure that bids' outcomes would correspond to those which are suggested by the undistorted choice objective. The two conditions are: first, a bidder will be able to gain control if and only if a majority of the target's shareholders prefer the bid to succeed; and, second, a shareholder will prefer a bid to succeed if and only if he views the expected acquisition price as higher than the independent target's value. As is easily seen, the two conditions together imply that a bidder will be able to gain control if and only if a majority of the target's shareholders view the expected acquisition price as higher than the independent target's value. The regulatory framework that I shall propose would attain undistorted choice by ensuring that each one of these two conditions would hold.

At present, however, both conditions do not hold. The first condition, that a bidder will not gain control unless a majority of the shareholders prefer the bid to succeed, is currently violated in two ways. First, bidders can currently gain effective control without attracting a majority of the target's shares; hence, even if shareholders' tender decisions perfectly reflected their preferences concerning the bid's success, the presence of a majority of shareholders who prefer the bid to succeed might not be necessary for a takeover. Second, and more importantly, shareholders' tender decisions do not currently reflect their preferences concerning the bid's success. As we have seen, shareholders might well tender even if they prefer the target to remain independent.

The second condition, that shareholders will prefer a bid to succeed if and only if they view the expected acquisition price as higher than the independent target's value, does not currently hold either. As we have seen, at present tendering shareholders can expect to receive in case of a takeover more than their prorata share of the acquisition price. Consequently, tendering shareholders may prefer a bid to succeed even if they view the expected acquisition price as lower than the independent target's value.

In sum, the conditions that would ensure an undistorted choice are currently violated for three reasons: (i) a bidder might gain control even if less than a majority of the shareholders tender; (ii) shareholders might tender their shares even if they do not prefer the bid to succeed; and (iii) tendering shareholders might prefer the bid to succeed even if they judge the independent target's value to be higher than the expected acquisition price. Each of the problems (i) - (iii) would be sufficient by itself to produce deviations from undistorted choice, and they all operate in bidders' favor.

Problem (ii) might seem to many to be the most important one.[71/] But I wish to emphasize that eliminating problem (ii) -- that is, ensuring that shareholders will tender if and only if they prefer the bid to succeed -- would not by itself ensure undistorted choice. It would still be necessary to address the possibility that shareholders might prefer the bid to succeed only because they expect to receive more than their prorata share of the acquisition price (problem (iii)), and the possibility that a minority preferring a takeover will be sufficient to bring it about (problem (i)).

Finally, I wish to emphasize that the current distortions (and the three reasons for their existence) are present in bids of all kinds -- whether they are partial or for all shares, whether or not they are expected to be followed by an immediate takeout. For one thing, these distortions are present whenever there is a gap between the bid's price and the expected post-takeover value of minority shares (and, consequently, also a gap between the bid's price and the expected per share acquisition price). And, as I have explained, such a gap is generally present in all bids.

### 7. A Note on The Magnitude of the Current Distortions

The preceding analysis has suggested that at present bids' outcomes are systematically distorted in bidders' favor. It is worth emphasizing, however, that I do not claim that the current distortions are irresistable, and that consequently a target's shareholders will never reject a bid and remain independent. A bid might well fail if a large majority of the target's shareholders

---

71/ And it is the only one which commentators have previously discussed. As far as I know, problems (i) and (iii) have not been noted in the literature as leading to distorted choice. See authorities cited in *supra* notes 7-11.

view the independent target's per share value as higher not only than the expected per share acquisition price but also than the bid's price, and if there is a widespread confidence that the bid will fail. Indeed, recent empirical work by Bradley, Desai, and Kim identified thirty-five instances in which a target's shareholders held out their shares in the face of a takeover bid, and the target remained independent at least for some time.[72/] It is worth noting that in these instances remaining independent indeed turned out to be value-maximizing: following the bid's rejection, the market price of the independent target's shares was significantly higher than the bid's price.

My claim is not that the current distortions are irresistable, but rather that they are very substantial. While a bid is not bound to be successful, it might well succeed even if it is socially desirable that it fail. There is a good chance for the rejection of a bid only when the shareholders' estimates of the independent target's per share value generally exceed the expected per share acquisition price by a considerable margin. Most of the instances identified by Bradley, Desai, and Kim presumably belong to this category. Conversely, a bidder might currently offer a per share acqusition price significantly lower than the shareholders' estimate of the independent target's per share value and still enjoy a high likelihood of its bid's success.

What I have thus far shown is that when a majority of a target's shareholders view the target's independent value as higher than the expected acquisition price, the target might well be nonetheless taken over. But one might still wonder, especially in light of the existence of some competition among potential acquirers, whether there are indeed many cases in which a majority of the shareholders view remaining independent as the target's value-maximiz-

---

72/ See Bradley, Desai & Kim, supra note 49.

ing course of action. This question I shall address in Part VI, where I shall explain why in all likelihood there is a significant number of such cases.

D. The Current Inequality of Treatment

Let us now turn to examine how a takeover's total acquisition price is currently distributed among the target's shareholders. The current inequality of treatment is rooted in the generally present gap between the post-takeover value of minority shares and the bid's price. Due to this gap, a shareholder's fraction of the total acquisition price in case of a takeover depends on the proportion of his shares, if any, that are acquired by the bidder for the bid's price. Shareholders who tendered their shares to a successful bidder have their shares, or most of them, acquired for the bid's price. In contrast, shareholders who did not tender have all of their shares turn into minority shares. Consequently, these latter shareholders end up with considerably less than their prorata share of the acquisition price. And, as already noted, there is in current successful bids a widespread and substantial incidence of non-tendering shareholders.

Now, the presence of a gap between the bid's price and the post-takeover value of minority shares is generally expected. Why, then, one might wonder, are there any non-tendering shareholders in successful bids?

We can identify three reasons for the presence of non-tendering shareholders. First, one group of non-tendering shareholders is composed of those who did not tender simply because they lacked a genuine opportunity to do so, because they were either unaware of the bid or unable to deliver their shares in time.[73/] Market professionals learn about a bid very shortly after it is

---

73/ See Nathan & Volk, Developments in Acquisitions and Acquisition Techniques under the Williams Act, Twelfth Annual Institute on Securities Regulations 159, 181-182 (1982); Welles, Inside the Arbitrage Game, 15 made; but some unsophisticated investors, especially those whose shares are held in street name, might take quite a few days, if at all, to learn about a bid. Market professionals are often able to deliver their share certificates within hours; but some unsophisticated investors, especially those whose shares are held in street names, might need a substantial time to make such a delivery. Thus, as a takeover bid is generally open only for a quite limited period, it is inevitable that a non-trivial number of unsophisticated shareholders will be unaware of it or unable to deliver their shares in time.

A second group of non-tendering shareholders in successful bids is composed of those who did not tender because they viewed the bid's price as lower than the independent target's per share value, <u>and</u> hoped that the bid would fail. As was explained above, a shareholder who views the bid's price as lower than the independent target's per share value might still tender out of concern that the bid is going to succeed regardless of his decision; but he might also hold out if he attaches a sufficient likelihood to the bid's failure. The second group of non-tendering shareholders, then, is composed of shareholders who did not tender due to their hope that the bid would fail, a hope which was later frustrated by the actions of their fellow shareholders. Had these shareholders known at the time of making their tender decisions that the bid would succeed, they would have tendered their shares.

The third group of non-tendering shareholders is composed of those shareholders who did not tender for tax reasons. These shareholders prefer retaining their shares as minority shares (with a value lower than the bid's price) to

---

(footnote continued)

<u>Institutional Investor</u>, August 1981, at 41, 46-51; Securities and Exchange Act Release No. 19, 366, [Current] Fed. Sec. L. Rep. (CCH) §83,306 (Dec. 15, 1982); SEC Exchange Act Release No. 18761, 47 Fed. Reg. 24, 338, 24, 340 (1982); Posen, Extended Proration Time for Tender Offers Proposed, Legal Times of Wash., Jul. 12, 1982, at 15, col.3.

selling them for the bid's price. A sale of the shares would constitute a tax event, and postponing tax liability might be beneficial, especially for shareholders who bought their shares for a very low price. Consequently, some shareholders might prefer to retain their shares as minority shares (and accept a lower pre-tax wealth) in order to reduce their tax liability.74/

Is it worthwhile highlighting the link between the problems of distorted choice and unequal treatment. The expected inequality of treatment distorts shareholders' tender decisions in two ways. First, it threatens deciding shareholders with a stick in case they hold out -- the penalty of receiving less than their prorata share of the acquisition price. Second, it offers deciding shareholders a carrot in case they tender -- the reward of receiving more than their prorata share at the expense of non-tendering shareholders. Consequently, as will be seen, ensuring an equal treatment would be instrumental to attaining undistorted choice.

As Part VI will explain, however, unequal treatment is undesirable not only because it leads to distorted choice but also because it is unfair. In examining this dimension of the unequal treatment problem, I shall focus on the first two groups of non-tendering (unequally treated) shareholders: those who had no opportunity to tender, and those who hoped that the bid would fail. Given that a takeover takes place due to their fellow shareholders' tender decisions, the shareholders in these two groups would wish to receive from the successful bidder a treatment equal to that of tendering shareholders; they would prefer to have their shares (or some of them) acquired for the bid's price than to have them all turn into minority shares. Had they had both the

---

74/ On the intricate issue of taxation of target shareholders see generally, B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders §§ 14.01 to .57 (4th ed. 1979).

knowledge that the bid would succeed and the opportunity to tender, they would have certainly tendered.

In discussing the unfairness of the current distribution, then, I shall abstract from the claims that might be made by those shareholders who did not tender to a successful bidder for tax reasons. These shareholders would not wish to receive from the successful bidder a treatment equal to that of tendering shareholders, for they do prefer retaining minority shares to having their shares acquired for the bid's price. They would have held out their shares no matter how certain they were that the bid would succeed and how perfect an opportunity to tender they had. To be sure, one might still wonder whether shareholders who did not tender for tax reasons are treated fairly; while they prefer holding minority shares to being in tendering shareholders' position, the choice with which they are faced might be unfair.[75/] But I shall ignore in this Article the clearly controversial claims that such shareholders might make. Rather, in examining the unfairness of the current inequality of treatment I shall focus on the much stronger claims that can be made by shareholders who held out their shares for non-tax reasons.

Finally, it might be worthwhile noting that, as will be later explained, market professionals and sophisticated investors are much less likely than non-professionals and unsophisticated investors to be hurt by the current inequality of treatment.[76/] This is the case because the former are less likely than the latter to belong to the two groups that are currently subject to an unfair inequality of treatment. First, market professionals and sophisticated investors are usually aware of bids and capable of delivering their

---

75/ Cf. Brudney, Equal Treatment of Shareholders in Corporate Distributions and Reorganizations, 71 Cal. L. Rev. 1076, 1126-31 (1983).

76/ See Part VI, Subsection B.2.a.

shares in time. Second, market professionals and sophisticated investors are less likely than others are to entertain a false hope that a bid which turns out to be successful would fail.

## IV. SOME UNSATISFACTORY REMEDIES

In Part V I shall put forward a regulatory framework that would provide an adequate remedy for the current problems of distorted choice and unequal treatment. But I should like first to consider remedies that have been suggested by others in the American literature, and to explain why I view these remedies as unsatisfactory.[77/]

The problems with which this Article is concerned have been discussed by many commentators and were recently considered by the SEC's Advisory Committee on Tender Offers.[78/] Below I shall examine the various remedies that have been proposed, and I shall demonstrate that none of these remedies is capable of adequately addressing the current problems. And it will be clear from the analysis that any combination of these remedies would not do either.

### A. Prohibiting Partial Bids

In examining the possible existence of distorted choice and unequal treatment, the SEC's Advisory Committee and subsequently the SEC limited their concern to partial bids (with special focus, as will be later discussed, on partial bids which are expected to be followed by an immediate takeout at a price lower than the bid's price).[79/] This reflects the Advisory Committee's and the SEC's view that problems of distorted choice and unequal treatment are

---

77/ The British approach, which is somewhat similar to the approach that I advocate, will be considered in Part V, Section D.

78/ *See* authorities cited in *supra* notes 7 - 11

79/ *See* Advisory Committee Report, *supra* note 10, at 24-27; SEC Release, *supra* note 11.

rooted in, and limited to, partial bids. A similar view has been expressed by many commentators and practitioners.[80/]

The view that problems of distorted choice and unequal treatment are rooted in, and limited to, partial bids obviously leads holders of the view to consider a ban on such bids. Indeed, one member of the Advisory Committee, in a dissenting report, endorsed such a ban.[81/] The majority of the Committee, however, was reluctant to recommend such a ban because of its belief that partial bids serve valuable economic roles.[82/] Instead of a ban on partial bids, the majority report recommended a compromise approach: discouraging such bids by requiring that they remain open for two weeks longer than bids for all shares. Some commentators, accepting the Committee's view that partial bids might serve socially beneficial functions, suggested that the proposed regulatory disincentive is nonetheless too weak, and proposed a stronger one.[83/] Reacting to the Committee's report, the SEC said that it was sensitive to the Advisory Committee's concern regarding partial bids but was unsure that the Committee's proposal was the best way to deal with this concern.[84/] Hence, the SEC stated that the issue requires further study, and it invited comments from the public on the issue.

---

80/ See, e.g., Greene & Junewicz, supra note 9, at 676-693. The British City Code also reflects a similar view -- that partial bids pose different and more severe problems than do bids for all shares. See Part V, Subsection D.4.

81/ See Advisory Committee Report, supra note 10, at 144-45 (Statement by Jeffrey Bartell).

82/ Id., at 24-26.

83/ See Greene & Junewicz, supra note 9, at 691-693, 738. They proposed that managers should be allowed to obstruct partial bids but not bids for all shares.

84/ See Statement of Shad, supra note 11, at 86, 679; SEC release, supra note 11.

Now, in my view the efficiency benefits that partial bids produce are likely to be much more limited than is commonly thought.[85] Consequently, I would unhesitatingly support a ban on partial bids if such a ban could address the problems of distorted choice and unequal treatment. But such a ban would be unable to address these problems. The reason for this is that the current problems are not limited to -- or even especially acute in -- partial bids; the popular view that this is the case rests on a misperception of the current problems. As the analysis of the preceding Part III has demonstrated, distorted choice and unequal treatment are currently present in all bids, whether partial or for all shares.

---

85/ The efficiency reason that is often suggested for partial acquisitions is that the potential buyers might lack sufficient funds to purchase all of the target's shares. Existing regulations discourage the use of exchange offers and lead bidders to generally employ cash tender offers. See Advisory Committee Report, supra note 10, at 20-21. A bidder might have limited liquidity, and might find it difficult or costly to raise cash. Consequently, the bidder might be able to make a partial cash bid, but might be unable to make a cash bid for all shares.

The above argument for allowing partial acquisition will lose much of its force in the near future, however. The SEC's Advisory Committee recommended facilitating exchange offers, and the SEC stated that it will follow this recommendation. See Statement of Shad, supra note 11, at 86,678. Once exchange offers are facilitated, bidders will be able to finance an acquisition by issuing their own securities. Indeed, by issuing an appropriate mix of securities a bidder will be able to finance an acquisition without any change in its debt-equity ratio. It is also worthwhile noting one clear source of inefficiency involved in partial acquisitions. In running the target as a partly-owned subsidiary, the acquirer will be concerned not only with maximizing the target's value, but also, and to a large extent, with distributing value from minority shareholders to itself. The acquirer's expected desire to take advantage of minority shareholders will likely produce various inefficiencies.

Thus, it does not appear that there are many instances where a partial ownership can produce substantial efficiency gains in comparison to a total ownership. But, in any event, prohibiting partial bids would not preclude a partial ownership structure. Supposing that there are some special efficiency advantages in a given bidder's owning only part of the target, the bidder could still buy all of the target's shares, resell a fraction of them to public investors, and end up with any fraction of the target's shares it wishes to hold. To be sure, such a resale would involve some wasteful transaction costs. But the possibility of such resale implies that the social cost of prohibiting partial bids would in no case exceed the size of these limited transaction costs.

The current problems are largely rooted in the presence of a gap between the bid's price and the expected post-takeover value of minority shares, a gap that is generally present in all current bids, including bids for all shares. Consequently, the problems of distorted choice and unequal treatment are substantially present in bids for all shares.[86/] First, shareholders' tender decisions in the face of a bid for all shares are distorted; for one thing, the prospect of a takeover in which non-tendering shareholders will end up with low-value minority shares subjects shareholders to a strong, distorting pressure to tender. Second, the success of a bid for all shares currently leaves non-tendering shareholders with less than their prorata share; and there is currently a significant presence of non-tendering shareholders in successful bids for all shares. In sum, at least as long as the expected post-takeover value of minority shares is generally lower than the bid's price, a ban on partial bids would do very little to ensure undistorted choice and equal treatment.

## B. Prohibiting Immediate Takeouts at Less Than the Bid's Price

The current problems, we have just observed, are largely rooted in the existence of a general gap between the bid's price and the expected post-takeover value of minority shares. Now, the presence of such a gap is most conspicuous in those instances where a takeover is expected to be followed by an

---

86/ The gap between the bid's price and the expected per share acquisition price is on average greater in partial bids than in bids for all shares. See Part III, Subsection B.3. This gap is important for delineating the range of values of the independent target's value where a distorted outcome is certain and not only possible. See Part III, Subsection C.4. Thus, the current distortion might be quantitatively somewhat stronger -- though qualitatively quite similar -- in partial bids than in bids for all shares.

immediate takeout with a consideration lower than the bid's price. This has naturally attracted substantial attention to such immediate takeouts. Indeed, the SEC's Advisory Committee and the SEC, which focussed on partial bids, paid a special attention to partial bids that are expected to be followed by such immediate takeouts (two-tier bids).

Professors Brudney and Chirelstein, the first academic commentators to seriously address the problems of distorted choice and unequal treatment, proposed a prohibition on immediate takeouts at less than the bid's price.87/ They suggested that, when a takeout occurs within a year after a takeover, the consideration paid to minority shareholders should be equal to the bid's price. A takeout at a lower price, they proposed, should be enjoined by the courts as unfair. Brudney and Chirelstein's proposal has received wide attention,88/ but has not been adopted by the courts.89/

The SEC's Advisory Committee expressed concern about the "coercive elements" of two-tier bids, and considered the possibility of recommending a regulatory ban on such bids.90/ One member of the Committee, in a dissenting report, indeed endorsed such a ban.91/ The Committee decided, however, not to recommend any restriction on partial two-tier bids beyond the slight regulatory disincen-

---

87/ See Brudney & Chirlestein, supra note 7, at 336-340; Brudney & Chirelstein, A Restatement of Corporate Freezeouts, 87 Yale L.J. 1354, 1359-65 (1978).

88/ See, e.g.,Toms, Compensating Shareholders Frozen Out in TwoStep Mergers, 78 Colum.L.Rev. 548 (1978); Lorne, A Reappraisal of Fair Shares in Controlled Mergers 126 U.Pa.L. Rev. 955 (1978); Easterbrook & Fischel, supra note 22.

89/ See e.g., Tanzer v. International Gen. Indus. 402 A.2d 382, 393-95 (Del. Ch.1979).

90/ See Advisory Committee Report, supra note 10, at 24-25.

91/ This was the same member who endorsed a ban on partial bids. See Advisory Committee Report, supra note 10, at 144-145 (Statement of Jeffrey Bartell).

tive that it proposed for all partial bids.[92/] The Committee's sense was that in instances where successful partial bids are not followed by an immediate takeout minority shareholders fare worse than in instances where successful partial bids are followed by an immediate takeouts with a consideration lower than the bid's price. Hence, the Committee reasoned, allowing such immediate takeouts increases the post-takeover value of minority shares and hence benefits minority shareholders.

Following the Advisory Committee's report, the SEC stated that the issue requires further study, and invited comments from the public on the issue.[93/] Also, as part of the required study, the SEC initiated, and then published the results of, an empirical study by the SEC's Chief Economist.[94/] The Chief Economists's findings confirmed the Advisory Committee's observation: the post-takeover value of minority shares is higher under immediate takeouts at less than the bid's price than under partial acquisitions unaccompanied by an immediate takeout. From these facts, the Chief Economist drew the same inference that the Advisory Committee did: he concluded that allowing immediate takeouts at less than the bid's price reduces the gap between minority shares' post-takeover value and the bid's price, and hence benefits minority shareholders.

Below I shall first point out that the SEC's Advisory Committee and the SEC's Chief Economist were mistaken in suggesting that a ban on immediate takeouts would on average increase the gap between the bid's price and the expected post-takeover value of minority shares. Such a ban, I shall suggest, would operate to narrow this gap. I shall go on, however, to show that while

---

92/ Id., at 24-25.

93/ See Statement of Shad, supra note 11, at 86, 679; SEC Release, supra note 11.

94/ See SEC Release, supra note 11.

the ban would narrow that gap, the ban would not constitute an adequate remedy for the current problems.

1. <u>The Ban Would Narrow the Gap</u>

The problem with the analysis of the Advisory Committee and the SEC's Chief Economist is that they drew a wrong inference from an accurate empirical observation. To see the flaw in their analysis, consider the choice that a successful bidder makes between effecting an immediate takeout and refraining from doing so. An immediate takeout with a consideration lower than the bid's price provides the acquirer with one way of taking advantage of minority shareholders. Refraining from an immediate takeout, however, might enable the acquirer to take advantage of minority shareholders in other ways -- through a distant takeout or through a diversion of the target's earnings. And the crucial point to remember is that the acquirer will presumably follow that strategy which is expected to enable the acquirer to take maximum advantage of minority shareholders.

Thus, those instances where the acquirer currently elects not to effect an immediate takeout are exactly the instances where the acquirer expects that, through diverting earnings or a distant takeout or both, it will succeed to leave minority shareholders with even less than it would have to pay them in an immediate takeout. This explains the empirical evidence which the Advisory Committee and the Chief Economist considered -- that minority shareholders fare worse in instances where an immediate takeout does not take place than in instances where it does. By the same logic, however, those instances where the acquirer currently effects an immediate takeout with a consideration lower than the bid's price are exactly the instances where the acquirer views such a takeout as the best means of taking advantage of minority shareholders.

It follows that a ban on immediate takeouts at less than the bid's price would likely enhance the post-takeover value of minority shareholders in those instances where such takeouts currently occur. And the ban would obviously have no effect on minority shares' post-takeover value in those instances where the acquirer currently elects not to effect an immediate takeout. Hence, the ban would clearly operate on average to narrow the current gap between the bid's price and the expected post-takeover value of minority shares.

2. <u>The Ban Would Not Eliminate the Gap</u>

I wish now to point out that while the considered ban would narrow the gap between the bid's price and the expected post-takeover value of minority shares, a substantial gap would still remain. This implies that the considered ban would not adequately address the current problems, at least not by itself. I shall a bit later on suggest that, in any event, seeking to eliminate the considered gap is altogether not the best approach to the current problems.

Suppose that the considered ban is adopted, and hence that acquirers effecting an immediate takeout are required to pay minority shareholders a consideration equal to the bid's price. Consequently, whenever an immediate takeout would be expected, the expected post-takeover value of minority shares would equal the bid's price. The current gap between the bid's price and the post-takeover value of minority shareholders would not be eliminated generally, however, as acquirers would frequently refrain from effecting an immediate takeout.

Note first that even at present, when acquirers can effect an immediate takeout at less than the bid's price, there are many instances where acquirers elect not to effect an immediate takeout. In these instances the post-takeover value of minority shares is generally lower than the bid's price due to the possibility that the acquirer will effect a distant takeout or divert to itself some of the target's earnings. Indeed, as explained above, minority shares' post-takeover value in these instances is even lower than the consideration which is currently required in an immediate takeout; for the acquirer would not have refrained from effecting such a takeout had it not believed that the possibilities of effecting a distant takeout and diverting earnings would present it with better means of taking advantage of minority shareholders. In all these instances where an immediate takeout does not currently occur, the considered ban would clearly leave intact the present substantial gap between the bid's price and the expected post-takeover value of minority shares.

Moreover, the considered ban would greatly increase the proportion of instances where an immediate takeout does not take place. For the ban would usually turn an immediate takeout into the acquirer's inferior strategy. Instead of effecting an immediate takeout and paying minority shareholders a consideration equal to the bid's price, most acquirers would presumably elect to rely on the possibilities of effecting a distant takeout or diverting earnings. They would effect a takeout, if at all, only after the passage of that period (a year, according to the Brudney-Chirelstein proposal) during which takeout terms would be strictly regulated. Thus, once the considered ban is adopted, instances where an immediate takeout does not occur would likely constitute the great majority of cases. Consequently, the contribution of the ban to closing the gap between the bid's price and the expected post-takeover value of minority shares would be much more limited than might be initially thought.

In sum, the ban would fall far short of generally eliminating the gap between the bid's price and the expected post-takeover value of minority shares. This conclusion might lead one to examine whether it is possible to eliminate the considered gap by supplementing the ban with some additional measures. As I explain below, however, eliminating the considered gap would not attain undistorted choice.

3. Eliminating the Gap Would Not Attain Undistorted Choice

Suppose that we adopt regulations (say, the considered ban in combination with some additional measures) that would generally eliminate the gap between the bid's price and the expected post-takeover value of minority shares. These regulations would obviously ensure an equal treatment of target shareholders in those instances where takeovers would take place. What I wish to point out, however, is that the considered regulatory strategy would not attain the undistorted choice objective. Rather, under the considered regulations the outcomes of bids would be systematically distorted against bidders -- that is, in an opposite direction to the current distortions.

To see this, examine the tender decision of a given shareholder under the considered regulations, supposing that the shareholder's estimate of the independent target's per share value is lower than the bid's price. Under the considered regulations, the expected per share acquisition price is always equal to the bid's price. Hence, according to the undistorted choice objective, the shareholder should tender his shares. But, as explained below, the shareholder might elect to hold out.

The shareholder will presumably ignore the effect of his tender decision on the bid's success, and will consider two cases: one in which the bid succeeds, and one in which it fails. Supposing that the bid is going to succeed, the shareholder will be indifferent between tendering and holding out, as the expected post-takeover value of minority shares is equal to the bid's price. Thus, the shareholder will limit himself to the question of whether in case the bid fails he will be better off tendering or holding out.

Now, the shareholder recognizes that his estimate of the independent target's value might be inaccurate, and if he knew more about other shareholders' estimates he might revise his. If the bid fails, that will mean that most shareholders have estimates which are higher not only than the shareholder's estimate but also than the bid's price. Consequently, the shareholder might conclude that in case the bid fails the market price of the independent target's shares will likely exceed the bid's price, and that in such a case he will be hence better off holding out his shares. To be sure, other shareholders' estimates might also be similar to (or even lower than) the shareholder's estimate; but then the bid will succeed, and this is a case to which the shareholder will pay no attention (given the considered regulations). Thus, because under the considered regulatory approach the shareholder will limit his considerations to the case in which the bid is going to fail, he might not tender even though he judges the offered acquisition price to be higher than the independent target's value.

It might be worthwhile to demonstrate the inadequacy of the considered regulatory approach in an alternative way. To this end, I wish to suppose for a moment that this regulatory approach would attain undistorted choice, and then show that this supposition leads to a contradiction. Supposing that the considered regulations would attain undistorted choice implies that under the regulations shareholders would hold out if and only if they view the independent target's per share value as higher than the bid's price. Hence, a target would remain independent if and only if most shareholders hold such a view. This in turn implies that the expected market price of the target's shares in case the bid fails would exceed the bid's price. But this means that a shareholder would find it in his interest to hold out even if his estimate of the independent target's per share value is lower than the bid's price. And this contradicts the initial supposition that shareholders' tender decisions would be undistorted.

## C. Allowing Obstructing Defensive Tactics

In the face of a takeover bid, target managements often use obstructing defensive tactics, such as litigation or creation of antitrust obstacles, which prevent the bid, at least temporarily, from going to the shareholders. The courts have thus far tolerated such obstructive tactics, and subjected them to the highly liberal business judgment rule. Recent academic opinion, however, has argued persuasively that such tactics should be prohibited, and that management should never prevent shareholders from making their own decisions as to whether a takeover bid will be accepted.[95]

The only argument that can be made for allowing obstructive tactics is one based on the current distortions of shareholders' choice. Since shareholders' choices are distorted, it might be in their interest, as well as in that of society, to prevent the decision from going to them. The problem of distorted choice, we have seen, results from the absence of a sole owner and the presence of a divided, dispersed ownership. Allowing obstructive tactics, it might be argued, gives management some veto power and thus enables it to bargain with potential acquirers as a sole owner would. Management, it might be hoped, will obstruct those takeover bids that do not offer an adequate acquisition price.

Indeed, several commentators -- Jarrel, Lipton, Lowenstein, and Greene and Junewicz -- suggested that due to the current distortions of shareholder choice it might be desirable to allow obstructing tactics, or at lease some such tactics.[96] In my view, however, allowing obstructive tactics is a very inadequate and costly way to deal with the distorted choice problem.

---

95/ See Easterbrook & Fischel, *supra* note 1; Gilson, *supra* note 1. I have expressed my support for a ban on obstructing tactics in Bebchuk, *supra* note 7, and Bebchuk, *supra* note 20.

96/ See Jarrel, *supra* note 8; Lipton, *supra* note 5; Lowenstein, *supra* note 5; Greene & Junewicz, *supra* note 9. These authors differ in the extent of their support for allowing obstructing tactics. Janel only pointed out that distor-

First, even if managers were perfectly loyal agents of the shareholders, allowing obstructive tactics would still be an extremely imperfect remedy. To start with, obstructive tactics are socially wasteful; litigation, for example, involves large wasteful expenditures, and creating antitrust obstacles might produce an inefficient allocation of assets. More importantly, allowing obstructive tactics hardly ensures that management will be able to block bids whose acceptance is not value-maximizing. While obstructive tactics have a substantial nuisance effect and often provide a delay, they commonly cannot block the offer of a persistent bidder.[97/] And the factors that determine whether obstructive tactics can prevent a given bid from proceeding -- such as the likelihood of getting an antitrust injunction -- are uncorrelated with the factors that determine whether rejection of the bid is indeed value-maximizing.

Second, managers are not perfectly loyal agents of the shareholders and they might well abuse their power to obstruct bids. The interests of managers and shareholders are unlikely to perfectly coincide in the acquisition context, and managers might pursue not only the shareholders' interests but also their own, private interests. Thus, management might refrain from obstructing an inadequate offer by management's favorite acquisition partner -- a potential buyer that promises management some attractive job prospects or side payments. Worst of all, management might elect to obstruct bids whose acceptance would

(footnote continued)

tions of shareholder choice might justify allowing obstructive tactics, but did not take a position on the issue. Lipton would allow such tactics (subject only to the very liberal test of the business judgment rule). Lowenstein would allow such tactics subject to a shareholder vote of approval. Finally, Greene and Junewicz would allow such tactics only in partial bids, to which they believed the distorted choice problem is limited.

97/ See, e.g., Austin & Mandula, Tender Offer Trends in the 1980's, Mergers & Acquisitions, Fall 1981, at 46-47.

be the shareholders' value-maximizing course of action. Management might choose to obstruct such an adequate bid in order to avoid a takeover altogether and retain its independence; or in order to extract side payments from the obstructed bidder; or in order to pave the road for a rival bidder that offers a lower acquisition price but a better deal for the managers.

The very real possibility that managers might choose to obstruct adequate bids undermines the objective of attaining undistorted choice. For it implies that a bidder might be unable to acquire the target even though a majority of its shareholders view the offered acquisition price as higher than the independent target's value. And the undistorted choice objective requires that such a bidder succeed in gaining control: it is an integral part of the undistorted choice objective that shareholder majority support be a sufficient condition for a takeover.

In sum, allowing obstructive tactics involves wasteful expenditures and does not move us even close to attaining the objective of undistorted choice. Indeed, it might even move us away from attaining this objective. Obstructive defensive tactics should therefore be prohibited, and we should seek other ways to address the problem of target shareholders' distorted choice.

### D. Relying on Charter Amendments by Potential Targets

In recent years various companies have adopted amendments to their articles of incorporation that would make an acquisition of the company more difficult or less desirable; examples are amendments that delay the process by which an acquirer can replace the board of directors, amendments that require a takeout to be approved by a supermajority, and amendments that prescribe a "fair price" in a takeout.[98/] Professor Carney, and Professors DeAngelo and Rice

---

98/ For a comprehensive survey and analysis of shark repellent amendments, see Gilson, The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept, 34, Stan.L.Rev. 775 (1982).

suggested that such charter amendments should be viewed as a remedy, provided by the market, to the problems of distorted choice and unequal treatment.[99/] Shareholders, argued Carney and DeAngelo and Rice, can address these problems by adopting appropriate shark repellent amendments.

Now, in Part V I shall identify the restrictions on bidders' behavior that would be necessary to address the problems of distorted choice and unequal treatment, and I shall advocate regulations that would impose such restrictions. Given the possibility of shark repellent amendments, the question naturally arises whether we would not do best if we refrain from legal intervention, and instead rely on targets to impose the desirable restrictions by adopting appropriate shark repellent amendments. In my view, however, imposing the necessary restrictions through regulation is the clearly preferrable approach, for the following reasons.

First, and most importantly, charter amendments have to be initiated by the management. And the managers are likely to be concerned not only with the problems of distorted choice and unequal treatment, but also, and perhaps mainly, with their own, private interests. Consequently, management is unlikely to seek the optimal arrangements for ensuring undistorted choice and equal treatment. In choosing the amendments it will initiate, management might well be strongly influenced by a desire to make a takeover more difficult and less likely, or by a desire to give itself some veto power that will enable it to extract substantial side benefits from a potential buyer.[100/] It is for this

---

99/ See Carney, supra note 7; DeAngelo and Rice, supra note 8.

100/ See Gilson, supra note 98. See also Coffee, supra note 7, at 1183-92.

reason that Professor Gilson suggested that shark repellent amendments be prohibited.101/

Second, even supposing that managers are perfectly loyal and are interested in adopting the optimal arrangements, it would not be generally possible to adopt these arrangements through charter amendments. The optimal arrangements will be delineated in the following Part, Part V. As will be seen, these arrangements would have to impose certain restrictions on the process through which bidders purchase shares from target shareholders. And current law makes it very difficult, if not impossible, to regulate the transfer of shares in a public corporation through charter amendments.102/

Third, even supposing that the optimal arrangements could be adopted through charter amendments, there seems to be no advantage in adopting these arrangements through private initiative rather than through regulation. Private solutions are usually viewed as advantageous in a context where there are different situations that do not lend themselves to one uniform optimal solution, and where private parties have superior information (vis-a-vis public officias) about their particular circumstances. In the present context, however, the problems -- and, as will be seen, the appropriate remedies as well -- can be analyzed in a general way. And since, as will be seen, the optimal arrangement is uniform across targets, there would be obvious advantages to adopting this arrangement in a centralized, regulatory way rather than through numerous private initiatives. The regulatory approach would produce economies of scale, save transaction and information costs, reduce uncertainty, and make planning easier.

---

101/ See Gilson, supra note 98.

102/ See generally A. Frey, J. Choper, N. Leech & R. Morris, Cases and Materials on Corporations 523-540 (2nd ed., 1977).

Finally, it is worthwhile noting that, presumably due to the above three reasons, antitakeover amendments have thus far fallen quite short of adequately addressing the problems of distorted choice and unequal treatment. Many companies have not adopted any such amendments, and many others have adopted amendments whose main effect is to entrench and strengthen the incumbent management's position. And even in those instances where antitakeover amendments do alleviate the problems of distorted choice and unequal treatment, they usually do not address these problems as well as the optimal arrangements would. Indeed, Carney, who put forward antitakeover amendments as a remedy, admitted that they fall short of eliminating the current problems.[103]

In sum, we should not rely on the evolution of appropriate charter amendments to remedy the problems of distorted choice and unequal treatment. As Gilson suggested, we should adopt a ban on antitakeover amendments in order to prevent their use by self-serving managers seeking to entrench their position. Instead of relying on charter amendments, we should identify the optimal arrangements for ensuring undistorted choice and equal treatment, and then prescribe these arrangements through regulation. To the identification of these optimal arrangements I shall now turn.

---

103/ See Carney, *supra* note 7, at

# V. A PROPOSED REGULATORY FRAMEWORK

This Part puts forward a regulatory framework that would adequately address the current problems of distorted choice and equal treatment. Section A outlines the proposed regulation, and Section B demonstrates that they would attain undistorted choice and equal treatment. Section C then makes several remarks concerning the design and operation of the proposed regulations. Finally, Section D compares the proposed regulations to the somewhat similar arrangements prevailing in Britain.

The costs of the proposed regulations will be discussed in Part VI; it will be suggested there that the regulations would likely involve no significant social costs. Because the proposed regulations seem to provide the best way of attaining the proposed objectives, the costs that the regulations would entail might also be viewed as the costs of having undistorted choice and equal treatment. It is for this reason that the discussion of the regulations' costs is deferred to Part VI, which will consider the desirability of undistorted choice and equal treatment.

## A. The Proposed Regulations

The proposed regulations would apply to all tender offers or exchange offers by a prospective buyer seeking to acquire a controlling interest in a target. The regulations would not apply to a tender offer or exchange offer aimed at the acquisition of, say, 5% of a target's shares. The regulations would hence have to include a specification of the fraction of a target's shares which would be assumed to provide a buyer with a "controlling interest." A bidder seeking to purchase more target shares than the specified threshold would fall under the proposed regulations. The crucial threshold should be determined in such a way that a shareholders holding less than that threshold block would be generally unable to exercise a substantial measure of effective control.

There might be of course disagreement concerning the determination of the threshold level which should be assumed to enable effective control. For concreteness I shall assume below that the chosen threshold level would be that of 25% ownership.[104/] This figure, I wish to emphasize, is only an example. Determining the appropriate figure requires further analysis, and such analysis might suggest a lower or higher figure. Such an analysis might also suggest specifying different threshold levels for targets with different sizes.[105/]

The proposed regulations might be divided into two parts: those concerning the treatment of tendering shareholders, and those concerning the treatment of non-tendering shareholders. And it will be useful to describe them in this order.

### 1. The Treatment of Tendering Shareholders

As was explained in Part III, at present a takeover might well take place even if a majority of the target's shareholders prefer the bid to fail. The proposed regulations concerning tendering shareholders would seek to ensure that a target will be taken over if and only if a majority of its shareholders prefer a takeover to take place. As will be seen, this would contribute substantially to attaining undistorted choice.

---

104/ The British City Code on Take-Overs and Mergers assumes that 30% ownership gives *de facto* control. *See* Panel on Take-Overs and Mergers, *The City Code on Take-Overs and Mergers* 11 (rev.ed 1976) (hereinafter cited as The City Code). The SEC's Advisory Committee suggested a figure of 20%. The Committee reported, however, that there was "strong disagreement" concerning this figure, and that there was some support for 15% or even 10%. *See* Advisory Committee Report, *supra* note 10, at 23.

105/ *See* Greene & Junewicz, *supra* note 9, at 671. They suggest that the fraction of a target's shares that is necessary for effective control decreases as the size of the target increases.

To understand how the proposed regulations would operate, it will be useful to first recall the analysis of shareholders' current tender decisions. At present, a given shareholder realizes that his tender decision will have little or no effect on the likelihood of the bid's success. Consequently, his decision will be little influenced by, and hence will not reflect, his preference concerning the bid's success. Moreover, the shareholder will not be able to limit his tender to only one of the two possible cases (the one in which a takeover will take place, and the one in which it will not). By tendering the shareholder will permit the bidder to purchase his shares in both possible cases, while holding out will mean that the shareholder will have to retain his shares in both cases.

The proposed regulations would enable shareholders to better express their preferences. First, the regulations would enable shareholders to better specify the conditions under which they are willing to have their shares acquired by the bidder. Specifically, shareholders would be able to permit acquisition of their shares in case of a takeover but not in case the target remains independent.

Second, in conjunction with the tendering of shares, shareholders would be able to separately indicate whether or not they would like the bid to succeed. Shareholders, for example, would be able to tender (and thus ensure that in case of a takeover they will receive their prorata share of the acquisition price) and at the same time indicate that they prefer the target to remain independent. With shareholders' preferences concerning a takeover elicited in this way, the regulations would seek to ensure that a takeover would take place if and only if it is preferred by a majority of the target's shareholders.

Turning to details, the medium through which shareholders would be able to express their preferences (concerning both the treatment of their shares and the bid's outcome) would be the letter of transmittal (tender form) which accompanies tendered shares. At present, tender forms (which bidders provide to potential tenderors) generally give the bidder an unconditional permission to purchase the tenderor's shares, regardless of the bid's outcome. I propose that tender forms should be formulated in such a way that a shareholder would be able to express his possibly different answers to the following three questions: (i) would he like his shares to be acquired in case the bid succeeds?; (ii) would he like his shares to be acquired in case the bid fails?; and (iii) would he like the bid to succeed or to fail?.

It might be initially thought that, to elicit the shareholders' preferences concerning these three issues, it would be necessary to have tender forms include three questions (or choices). Actually, at most two questions would be necessary. The reason for this is that all tendering shareholders can be presumed to wish to have their shares acquired in case of a takeover. For one thing, as the expected post-takeover value of minority shares is generally lower than the bid's price, shareholders will by and large wish to have their shares acquired in case of a takeover. The only reason as to why a shareholder might wish to end up with minority shares in a taken over target is that the shareholder might wish for tax reasons to avoid selling his shares. But such a shareholder will presumably not wish to sell his shares also in case that the bid fails, and hence will hold out his shares altogether.

Thus, tendering shareholders can be presumed to wish to have their shares acquired in case of a takeover, and tender forms could hence start with a statement permitting the bidder to purchase the tenderor's shares in case of a takeover. Following this statment, tender forms would have to include the following one or two questions.

One question that tender forms would always have to include would seek to find whether the shareholder prefers the bid to fail or to succeed. To this end, the shareholder might be simply asked whether or not he approves a takeover (i.e., the bidder's purchasing of a controlling interest). The shareholder would be able to answer this question either affirmatively or negatively, presumably by marking an appropriate box. As will be explained below, shareholders' responses to this question would determine the bid's fate. The response of tendering shareholders to the question would divide them into two groups: those who make approving tenders (give an affirmative answer to the question whether or not they approve a takeover), and those who make disapproving tenders. As will be seen, those who prefer the target to be taken over would choose to make approving tenders, and those who prefer the target to remain independent would elect to make disapproving tenders.

A bidder that would wish to have the option of purchasing some tendered shares in case the bid fails would have to include in its tender form a second question. This second question would ask the tenderor whether or not he permits the bidder to purchase his shares in case a takeover does not take place (that is, in case the bidder is not going to end up with a controlling interest). The tenderor's answer to this question would of course determine how his shares would be treated in such a case. Again, a shareholder would be able to give either an affirmative or a negative answer to this question, presumably by marking an appropriate box.

Under the proposed regulations, all shareholders who are aware of the bid (with the exception of those who wish to retain their shares for tax reasons) would generally tender to a bid that has a non-trivial chance of succeeding. They would all wish to ensure that in case of a takeover they would not end up with minority shares. And by tendering they would be able to ensure this, and without necessarily helping the bid to succeed or permitting the bidder to purchase their shares in case the target remains independent.

Under the proposed regulations, however, the number of tendered shares would not by itself determine the bid's success. The bid's success would depend on shareholders' choices between tendering approvingly and disapprovingly. The bidder, I propose, should be allowed to purchase a controlling interest in the target only if it receives the specified crucial number of <u>approving tenders</u>. At this stage, I shall assume that the requirement would be for the bidder to receive approving tenders from a majority of the target's shares. Later in this Part (Subsection C.3) I shall discuss possible modifications and refinements of the required number of approving tenders.

Suppose, for example, that 90% of a target's shareholders tender, with 70% making approving tenders and 20% making disapproving tenders. In this case, the bidder would be able to purchase a controlling interest, and a takeover would take place. Note that all the tendering shareholders, including those who make disapproving tenders, express their wish to have their shares acquired in case of a takeover. In purchasing shares the successful bidder would have to treat all these tendering shareholders equally. If the bid is for all shares the bidder would purchase all tendered shares, while in a partial bid a proration would take place.

Suppose, however, that 70% of the shareholders make disapproving tenders and only 20% make approving tenders. In this case, the bidder would be unable to purchase a controlling interest in the target. The bidder might still be able to purchase a non-controlling block; to this end the bidder might purchase shares of those tenderors who (by answering affirmatively the tender form's second question) permitted the bidder to purchase their shares in case that the bid fails. The bidder would have to treat all such shareholders equally. That is, if more shares would be available to the bidder than it would wish or be able to purchase for its non-controlling block, a proration would take place.106/

2. The Treatment of Non-Tendering Shareholders

As explained above, the proposed regulations concerning the treatment of tendering shareholders would curtail the incidence of non-tendering shareholders in successful bids. Shareholders who are aware of a bid which has a non-trivial chance of succeeding would by and large tender, at least in order to secure receiving their prorata share in case of a takeover. Still, there would remain some incidence of non-tendering shareholders; for one thing, there would be some shareholders who would lack an opportunity to tender. The regulations that I outline below would regulate the treatment of such non-tendering shareholders in case of a takeover.

The proposed regulations would enable non-tendering shareholders to receive in case of a takeover something close to their prorata share of the acquisition price. These regulations would obviously serve to attain an approximately equal treatment of the target's shareholders. Moreover, as will be seen, these regulations would also contribute to attaining undistorted choice. An expected prorata division would be necessary to ensure that tendering shareholders would prefer a takeover -- and hence would make approving tenders -- if and only if they would view the expected acquisition price as higher than the independent target's value.

---

106/ It would be possible that the bidder would fail to receive the required majority of approving tenders, but that more than 25% of the shareholders would permit the bidder to purchase their shares in case that the bid fails. In this case, the bidder would of course be prevented from buying all the shares of these shareholders, and would have to limit its purchases to at most 25% of the target's shares.

It should be emphasized that the proposed regulations would not provide non-tendering shareholders of a taken over target with exactly their prorata share of the acquisition price, but rather with slightly less than that. Maintaining such a small gap will be seen to be necessary in order to provide shareholders who are aware of a bid with an incentive to tender (whether approvingly or disapprovingly).

a. Regulating Immediate Takeouts

Following the takeover, a bidder that wishes to buy all of the target's shares might proceed to effect an immediate takeout. The proposed regulations would ensure that the value of the takeout consideration would be close to that of the bid's price.

An immediate takeout should take place within three months after the takeover. Minority shareholders should be paid with the same mix of cash and securities used to pay for tendered shares, and the takeout consideration should have a nominal value equal to the bid's price.[107/] This implies that the real value of the takeout consideration would be slightly lower than that of the consideration that would be paid for shares acquired on tender. For the takeout consideration would be paid three months after the takeover, and a delay of three months in receiving a given nominal amount involves a loss of interest of about (given current interest rates) two-three percentage points.

---

107/ If the bid's consideration would be fully in cash, the takeout consideration would be simply the same amount of cash per share. When the bid's consideration would include a securities component, some special rules would be necessary.

The need to use the same mix of cash and securities in both the bid and the takeout would impose no efficiency costs once the Advisory Committee's recommendation to facilitate exchange offers is adopted. The SEC stated that it will follow this recommendation. See Statement of Shad, supra note 11, at 86,678-79.

Once the proposed regulations are introduced, taken out minority shareholders should not be able to demand, on the basis of appraisal rights or otherwise, a takeout consideration higher than the one prescribed by the regulations. That is, the regulations would not merely establish a floor, but rather would totally determine the takeout consideration. As already noted, non-tendering shareholders should expect to receive a value slightly less than the bid's consideration; they should have no reason to expect that in case of a takeover they will be better off than, or even as well as, tendering shareholders. Otherwise, shareholders who are aware of the bid would be induced to hold out their shares.

b. Providing Redemption Rights

The described takeout regulations would ensure that when a takeover is followed by an immediate takeout non-tendering shareholders would end up with close to their prorata share of the acquisition price. But, of course, a successful bidder might elect not to effect an immediate takeout. In such a case, I propose, non-tendering shareholders should be provided with redemption rights which would ensure that they would be able, if they would so wish, to receive something close to their prorata share acquisition price. Again, maintaining a slight gap between what non-tendering shareholders and tendering shareholders would end up with would be necessary in order to provide shareholders with an incentive to tender (whether approvingly or disapprovingly).

To exercise their redemption rights, non-tendering shareholders would have to submit their shares to the acquirer for redemption within three months after the takeover. At this time, three months after the takeover, the acquirer would pay the prescribed redemption consideration for submitted shares that it would redeem. As will be explained below, in a bid for all shares the bidder would have to redeem all submitted shares, while in a partial bid the bidder would usually have to redeem only a fraction of the submitted shares. In both cases the consideration paid for redeemed shares would have to be paid in the same mix of cash and securities used to pay for shares purchased on tender, and it would be required to have a nominal value equal to the bid's price. Thus, the real value of the redemption consideration would be slightly lower than that of the bid's consideration.

Whether the bidder would have to redeem all or only some of the submitted shares would depend, as just noted, on whether the bid is for all shares or partial. Consider first the case of a bid for all shares. In such a case, which is one where the bidder expressed a willingness to purchase all of the target's shares, non-tendering shareholders should have the option to redeem all of their shares for the prescribed redemption consideration. Note that in a successful bid for all shares tendering shareholders would have all their shares purchased for the bid's price. Thus, enabling non-tendering shareholders to redeem all their shares for the prescribed redemption consideration would enable them to end up with a per share value close to that per share value with which tendering shareholders would end up.

Consider now the case of a partial bid, which is one where the bidder explicitly stated its wish to limit its purchases to a limited fraction of the target's shares, say 60%. In such a case, the rules concerning redemption rights would not require the bidder to end up with more than 60% of the target's shares. At the same time, the rules would ensure that non-tendering shareholders would be able to receive something close to their prorata share of the acquisition price. To this end, the redemption proration ratio should be the same as the bid's proration ratio -- that is, the fraction of shares submitted by non-tendering shareholders for redemption that would be purchased for the redemption consideration would have to be the same as the fraction of tendered shares that would be purchased for the bid's consideration. The identity between the bid's proration ratio and the redemption ratio would ensure that non-tendering shareholders would be able to end up with a per share value close to that per share value with which tendering shareholders would end up.108/

Finally, I wish to emphasize that the rules concerning redemption rights should be designed so that all non-tendering shareholders would have a genuine opportunity to take advantage of these rights. To this end, the acquirer should be required to furnish all minority shareholders (say, within six weeks after the takeover) with a written notice about the takeover, the acquirer's decision not to effect an immediate takeout, and the redemption option avail-

---

108/ Of course, the required identity between the two proration ratios will not be totally finalized until the total number of tendered shares and shares submitted for redemption is established. Until then it cannot be determined with precision which proration ratio will lead to the bidder's purchasing 60% of the target's shares. While the proration ratio will not be finalized until the redemption rights' expiration date, however, it is clear that it will be at least 60%; consequently, the bidder will be able upon the bid's expiration to purchase and pay for most of the tendered shares it will eventually end up purchasing.

The schedule of the successful bidder's paying for and purchasing shares will consequently look as follows. Following the successful bid's expiration, the bidder will purchase, and pay the bid's price for, at least 60% of the shares that were tendered either unconditionally or conditionally; and the bidder will continue to hold the rest of the tendered shares until the proration ratio is finalized. The bidder will be required to purchase and pay for at least 60% of the tendered shares because the proration ratio will be at least 60% even if all the non-tendering shareholders exercise their redemption rights. The proration ratio will be determined at the end of the three-months period for exercising redemption rights; supposing that the shares submitted for redemption and those tendered either unconditionally or conditionally add up to 90% of the target's shares, the proration ratio will be 66.6%. The bidder will then purchase 66.6% of all shares submitted for redemption, and that fraction of the shares that were tendered which is necessary to bring the purchased fraction of such shares up to 66.6%; and the bidder will then return all unacquired shares.

able to them.[109/] This notice, and the three month period for exercising redemption rights, would enable virtually all minority shareholders to take advantage of their redemption rights.

## B. Effectiveness in Attaining Undistorted Choice and Equal Treatment

### 1. Undistorted Choice

I wish first to point out that under the proposed regulations the vast majority of a target's shareholders would tender their shares. Consider the position of a shareholder who is aware of the bid, and who does not have compelling tax reasons for avoiding a sale of his shares. If the shareholder wishes to have his shares acquired for the bid's price whether or not the bid succeeds, then he will clearly elect to tender (and he will permit the bidder to purchase his shares in case that the bid fails). But even supposing that the shareholder wishes to have his shares acquired only in case of a takeover, he will still elect to tender (giving no permission to purchase his shares in case that the bid fails), in order to ensure receiving his prorata share in case of a takeover. To be sure, the regulations concerning non-tendering shareholders would ensure that if the shareholder holds out and a takeover takes place, he would be still able to secure something close to his prorata share. Still, in case of a takeover holding out would lead, in comparison to tendering, to losing a three-months-interest of (about) three percent.

I wish now to point out that under the proposed regulations tendering shareholders' choices would be undistorted. That is, a tendering shareholder

---

109/ To facilitate a fully informed decision by minority shareholders, the acquirer might also be required to include in its notice certain specified information concerning the hazards involved in holding minority shares.

would elect to make an approving tender if and only if he views the expected acquisition price as higher than the independent target's value. To demonstrate this, I shall show below that under the proposed regulations the following two conditions would hold: (i) a tendering shareholder would tender approvingly if and only if he would prefer a takeover to take place; and (ii) a tendering shareholder would prefer a takeover to take place if and only if he views the expected acquisition price as higher than the independent target's value.

It is easy to see that under the proposed regulations a tendering shareholder would elect to tender approvingly if and only if he would prefer the target to be taken over. The shareholder's choice between making an approving tender and a disapproving one will matter only if his decision is pivotal -- that is, if there would be a majority of approving tenders with his approving tender but not without it. In such a case, his making an approving tender would lead to a takeover, while his making a disapproving tender would lead to the bid's failure and preserve the target's independence. Consequently, he would choose to make an approving tender if and only if he would prefer a takeover to take place.

Similarly, it is also easy to see that under the proposed regulations a tendering shareholder would prefer a takeover to take place if and only if he views the expected acquisition price as higher than the independent target's value. The reason for this is that under the proposed regulations a tendering shareholder would expect to end up in case of a takeover with his prorata share of the acquisition price. At present, tendering shareholders can expect to end up in case of a takeover with considerably more than their prorata share of the acquisition price; for non-tendering shareholders, who are generally present in substantial numbers, are currently expected to end up with considerably less than their prorata share. Under the proposed regulations, however, this would change: as will be presently demonstrated, the proposed regulations would lead to a roughly equal division of the acquisition price in case of a takeover, and hence tendering shareholders would no more expect to receive more than their pro rata share. Consequently, a tendering shareholder would prefer that a takeover take place if and only if he would view the acquisition price as higher than the independent target's value.110/

In sum, under the proposed regulations the great majority of a target's shareholders would tender their shares to the bid, and tendering shareholders would tender approvingly if and only if they view the expected acquisition price as higher than the independent target's value. It follows that the proposed regulations would bring us fairly close to attaining the undistorted choice objective.

While the proposed regulations would bring us very close to attaining undistorted choice, they might not do a "perfect" job. One reason for this is that while most target shareholders would tender their shares, some would not and hence their estimates of the independent target's value would not count. Another reason is that some tendering shareholders, in choosing between tendering

---

110/ I wish to point out that the proposed regulations would not lead to a problem that I discussed, see Part III, Subsection C.3, when I demonstrated that eliminating the gap between the bid's price and the expected post-takeover value of minority shares would not attain undistorted choice. Once this gap is eliminated, I pointed out, a shareholder's tender decision would not be based on his estimate of the independent target's value. For his decision would matter only in case most shareholders hold out and the bid fails. And his estimate conditional on the occurrence of this case is higher than his unconditional estimate of the independent target's value.

In contrast, under the proposed regulations a shareholder's choice between making an approving tender and making a disapproving one would matter only in case the shareholders are roughly split on the question whether or not the expected acquisition price exceeds the independent target's value. Consequently, in making his choice the shareholder will base his decision on his estimate of the independent target's value rather than on the significantly revised estimate.

approvingly and disapprovingly, might have goals other than maximizing the value of their shares. Both these (limited) problems will be considered in Section C.3, where I shall discuss modifying the required number of approving tenders in order to perfect the regulations' effectiveness.

2. Equal Treatment

The proposed regulations would pratically attain the equal treatment objective. In case of a takeover, all shareholders who wish to receive their prorata share of the acquisition price would be able to get it, or at least something close to it. The proposed regulations would signficantly increase the proportion of tendering shareholders in successful bids, and these shareholders would be all treated with perfect equality. And as to the remaining non-tendering shareholders, the proposed regulations would ensure that they would be able to receive, if they would so wish, something close to their prorata share of the acquisition price.[111/]

Another way to show the proposed regulations' effectiveness in attaining equal treatment is by reference to the current unequal treatment. As I pointed out, in current takeovers there are two significant groups of non-tendering shareholders who would like to receive their prorata share of the acquisition price but end up with all their shares becoming minority shares: (i) shareholders who hoped that the bid would fail, and wished to retain their shares in such a case; and (ii) shareholders who had no opportunity to tender. As to members of

---

111/ To be sure, in those instances where an acquirer would not effect an immediate takeout, there would possibly be some shareholders who would end up with less than their prorata share -- shareholders who for tax reasons would prefer not to exercise their redemption rights. These shareholders, however, would be ones who, fully aware of the takeover and of their redemption rights, would choose to retain their minority shares rather than receive their prorata share of the acquisition price.

group (i), under the proposed regulations they would be able to tender without permitting the bidder to purchase their shares in case that the bid fails; consequently, they would end up in case of a takeover with the same per share value as all tendering shareholders. And as to members of group (ii), the proposed regulations concerning non-tendering shareholders would ensure that they would be able to secure, if they would so wish, something close to their prorata share of the acquisition price.

Finally, it might be worthwhile highlighting again the link between the equal treatment that the proposed regulations would secure and the undistorted choice that they would attain. Because under the proposed regulations the acquisition price in case of a takeover would be expected to be divided prorata, tendering shareholders would not expect to receive in case of a takeover more than their prorata share. And this would induce tendering shareholders to tender approvingly if and only if they view the expected acquisition price as higher than the independent target's value. Thus, the equal treatment that the proposed regulations would secure would be instrumental to their attaining undistorted choice.

## C. Remarks on the Design and Performance of the Proposed Regulations

The purpose of the remarks below is to highlight and discuss some significant aspect concerning the design, operation, performance, and possible modification of the proposed regulations.

### 1. The Knife's Edge Problem

As explained above, under the proposed regulations a shareholder's choice between tendering approvingly and disapprovingly would affect his position only in the very-low-likelihood case that his choice would prove decisive for the bid's success. It is indeed this fact which would ensure that the shareholder's choice would be an undistorted one. The fact that a shareholder's choice (between tendering approvingly and disapprovingly) would have an effect only with a very low likelihood, however, might lead some to be concerned that shareholders would have no incentive to make that choice, or at least no incentive to make it in an informed way.

Specifically, there are two concerns that need to be addressed. The first concern that I wish to consider is that shareholders would have no incentive to respond to the question (posed to them on tender forms) whether or not they approve a takeover. This concern is similar to ones that are expressed in other contexts -- such as the concern that shareholders have no real incentive to vote in a proxy contest, or the concern that citizens have no real incentive to vote in political elections. While this kind of concern is valid in these latter contexts, however, it is not justified in the contest of the proposed regulations.

Voting in a proxy contest or in political elections involves non-negligible "transactions costs." It is the presence of these costs which leads to the concern that, given the very low likelihood of affecting the outcome, some potential voters would be unwilling to bear these costs and vote. In contrast, under the proposed regulations tendering shareholders would have to bear no extra transaction costs in order to register their approval or disapproval of the bid. These shareholders would not be tendering in order to register their approval or disapproval, but rather in order to ensure that their shares will be acquired in case of a takeover (and possibly also in order to allow the bidder to acquire their shares in case that the bid fails). And for these tendering shareholders -- who would be tendering their shares with an accompanying tender form anyway -- all that registering approval or disapproval would involve is marking an appropriate box on the tender form.112/

Thus, tendering shareholders would have no reason to refrain from registering their approval or disapproval of a takeover. This still leaves the second concern that has to be considered: would shareholders have any real incentive to form a serious, informed judgment about the independent target's value? Now, to be sure, a shareholder would have no real incentive to devote time and resources for the sole purpose of improving the quality of his choice between tendering approvingly and disapprovingly. Thus, the considered concern would be totally justified if improving that choice were the only reason as to why shareholders would wish to form a judgment about the independent target's value. This is not the case, however.

The question of the target's value is of great interest to all of the target's shareholders. It is important to their initial decision to buy the target's stock, and to their continuous decision to retain, rather than sell, their shares. Of course, sophisticated investors might devote more resources than unsophisticated investors do to studying the target's value and to updating their estimate. But all shareholders form some guiding estimates of the target's value. And the shareholders would use these estimates in making their choice between tendering approvingly and disapprovingly.

2. Superiority to a Separate Vote

Under the proposed regulation, a takeover would essentially require an expression of approval by a majority of the target's shareholders. This approval would not have to be obtained in a separate vote, however, but rather

---

112/ And if one is still concerned that shareholders would not bother to answer the question whether or not they approve the bid, it is possible to prescribe that tender forms would not be valid (i.e., the shares would not be considered to be tendered) if they do not contain an answer to this question.

in conjunction with the tendering of shares by shareholders. I wish now to point out the advantages of the proposed approach to an arrangement that would require a separate vote of approval.

An arrangement which would require a separate vote of approval as a condition for a takeover would roughly operate as follows. A bidder seeking to acquire a controlling interest would have to submit his bid to a vote by the target's shareholders and to obtain a majority approval. The vote's result would become known before shareholders would have to irrevocably make their tender decisions. When the bidder would fail to obtain the necessary majority approval, it would be prevented from purchasing a controlling block; shareholders would then tender their shares only if they would like to have them acquired in case that the bidder elects to purchase a non-controlling block. When the bidder would succeed in obtaining the necessary majority approval, it would be allowed to acquire a controlling interest. Shareholders who are aware of the bid would then correctly assume that a takeover would take place, and would by and large tender their shares. And in case of a takeover, regulations concerning immediate takeouts and redemption rights would ensure that non-tendering shareholders would be able to secure something close to their prorata share of the acquisition price.113/

There are three reasons as to why I find the proposed regulations superior to an arrangement based on a separate vote, like the one described above. First, many shareholders who are aware of a bid might well elect not to participate in a separate vote (whether or not they prefer the bid to succeed).

---

113/ Ohio recently adopted a separate vote arrangement, but without the necessary accompanying regulations concerning non-tendering shareholders. See Ohio Rev. Code. Ann. §1701.83.1 (Page Supp. 1982). The Ohio statute might well be unconstitutional in light of Edgar v. MITE Corp., 457 U.S. 624 (1982).

For a shareholder's vote would have a very low likelihood of affecting the vote's outcome, and casting the vote would involve non-negligible transaction costs. As explained above, however, such a problem would not exist under the proposed regulations. Under these regulations, tendering shareholders would be able to register their approval or disapproval of the bid without bearing any extra transaction costs (beyond those involved in tendering).

Second, shareholders' choice between tendering approvingly and disapprovingly would be likely better informed than the choice that they would make in a separate vote arrangement between voting in favor of a takeover and voting against it. Under the proposed regulations, tendering shareholders would choose between approving or disapproving a takeover at the same time that they would be choosing whether or not to permit the bidder to acquire their shares in case that the bid fails. Unlike the former choice, the latter choice would have a significant likelihood of affecting the shareholder's position. Consequently, shareholders might devote time and resources to figure out whether or not they would be better off retaining their shares in case the bid fails. In making this decision shareholders would study the independent target's per share value, and this study would inform, and hence improve, the choice that they would be making at the same time between tendering approvingly and disapprovingly.

Third, requiring a separate vote of approval would make the acquisition process more inconvenient, less economical, and unnecessarily slow. Under the proposed regulations shareholders would have to send materials only once, as the expression of approval or disapproval would be done in conjunction with the tendering of shares. In contrast, a separate vote might require shareholders to act twice -- once to case a vote, and possibly again to tender their shares. The two-stage process of a separate vote would not only involve higher transaction costs but would also cause a delay in consummating acquisitions.

And as long as the choice of the target's shareholders is undistorted, prompt consummation of acquisitions is desirable.

3. The Required Number of Approving Tenders

Thus far I have assumed that the regulations would allow bidders to purchase a controlling interest only if they would attract approving tenders from a majority of the target's shareholders. I wish now to discuss possible refinements of the required number of approving tenders. The aim of such possible refinements would be to perfect the effectiveness of the proposed regulations in attaining undistorted choice. In particular, there are two problems that should be considered: the possible presence of non-tendering shareholders, and the possibility of the bidder's owning some pre-bid (non-controlling) stake in the target.

Let us first consider the problem of the presence of non-tendering shareholders. Suppose that the bidder owns no shares in the target, that 90% of the shareholders tender their shares, and that 10% do not. Suppose further that 48% of the shareholders (i.e., 53% of the tendering shareholders) make approving tenders. Requiring the bidder to attract approving tenders from a majority of the target's shareholders would lead to the considered bid's failure. Now, according to the undistorted choice objective the bid should fail if and only if a majority of the target's shareholders view the expected acquisition price as lower than the independent target's value. Whether or not the bid's failure is socially desirable thus depends on our assumptions concerning the judgments of the 10% non-tendering shareholders.

The non-tendering shareholders presumably held out their shares not because of their high estimates of the independent target's value but due to either a lack of an opportunity to tender or special tax circumstances; under the proposed regulations, a high estimate of the independent target's value would by itself lead a shareholder not to hold out but rather to make a disapproving tender. Thus, there is no reason whatsoever to assume that the 10% non-tendering shareholders estimate the independent target's value to be higher than the expected acquisition price. Indeed, there is no reason to assume that the distribution of estimates among the 10% non-tendering shareholders is radically different from, or even dissimilar to, the distribution of estimates among the 90% tendering shareholders.

It follows that requiring the bidder to receive approving tenders from a majority of the target's shareholders (i.e., 56% of the tendering shareholders in the considered case) would likely introduce a slight bias against the bidder. Rather, it seems to me that it would be better to require the bidder to attract approving tenders only from a majority of the tendering shareholders (i.e., from 45% of the target's shareholders in the considered case). Assuming that the distribution of estimates among the 90% tendering shareholders is fairly representative of the distribution of estimates among all of the target's shareholders, such a modification would produce outcomes that best approximate those that are suggested by the undistorted choice objective.

Let us now consider the issue of the bidder's initial shareholdings in the target. Suppose that the bidder initially controls, through a wholly-owned or partially-owned subsidiary, 10% of the target's shares. Under the present takeover rules, the bidder would have no reason to have these shares tendered to itself. However, if the bid's success would depend on receiving a given number of approving tenders, the bidder would lead its subsidiary to tender its shares approvingly to the bidder. The question is whether such approving tenders should count, and in my view they should not. The bidder, it seems to me, should be required to attract approving tenders from a majority of the "disinterested" tendering shareholders.

Under the proposed regulations, I explained, a tendering shareholder would make an approving tender if and only if the shareholder prefers a takeover to take place. Now, a "disinterested" shareholder's preference concerning a takeover would be determined by the sole objective of maximizing the value to himself of his shareholdings. Consequently, under the proposed regulations such a shareholder would prefer a takeover if and only if he views the expected acquisition price as higher than the independent target's value. Thus, a "disinterested" shareholder's choice between making an approving tender and a disapproving tender would reflect the shareholder's judgment as to how the above two values compare.

In contrast, the considerations that would guide the decisions that the bidder would make qua shareholder would not be limited to maximizing the value of his initial shareholdings. In particular, the bidder would clearly prefer the bid to succeed (otherwise it would not have made the bid), no matter how high the bidder's estimate of the independent target's value. Consequently, an approving tender by the bidder would not necessarily reflect the bidder's judgment as to how the offered acquisition price compares with the independent target's value. It is for this reason that I propose that approving tenders of shares controlled directly or indirectly by the bidder should not count, and that the bidder should be required to attract approving tenders from a majority of the disinterested tendering shareholders.[114/]

---

114/ Note that it would be still quite profitable for a prospective bidder to make secret pre-bid purchases of the target's shares. (The bidder can purchase up to 5% of the target's shares without being required by the Williams Act to disclose it purchases. See 15 U.S.C. §78n(d)(1)(1976)). To be sure, under the proposed regulations such purchases would not increase the likelihood of the bid's success (nor should they). But the purchases would in all likelihood enable the bidder to make a substantial gain, whether its bid succeeds (in which case the bidder would save the acquisition premium on the stock it already owns) or fails (in which case the market price of the target's shares would likely be significantly higher than the pre-bid price). See Bebchuk, supra note 7, at 1035.

Another issue that I wish to raise is the question whether the category of "interested" shareholders should be expanded beyond the bidder and its subsidiaries. There might be other shareholders whose preferences concerning a takeover are governed by considerations other than maximizing the value of their shareholdings. In particular, the target's managers might prefer the bid to fail -- and consequently might make disapproving tenders with whatever shares they own -- even if they view the expected acquisition price as higher than the independent target's value.

In sum, it seems that we would do best to require the bidder to attract approving tenders not from a majority of the target's shareholders but rather from a majority of the disinterested tendering shareholders. But in any event, the precise determination of the required number of approving tenders is not central to my thesis, and can be left open at this stage.115/

4. The Proposed Regulations and Partial Acquisitions

At present, many bidders seek to purchase only a limited fraction of the target's shares. And there have been proposals to seek a remedy to the current problem by prohibiting or penalizing partial bids.116/ As I noted, however, various commentators, the SEC's Advisory Committee, and the SEC expressed the view that partial bids might serve socially beneficial purposes, and that

---

115/ The choice among the various plausible versions is not of great practical significance. In most instances, the different versions would not lead to different outcomes. They would lead to different outcomes only in case that the shareholders would be roughly split in their views as to how the expected acquisiton price compares with the independent target's value. And in such a case, the difference between the two possible outcomes in terms of efficiency would likely be small.

116/ *See* Part IV, Section A.

prohibiting or penalizing partial bids would thus produce social costs. I wish therefore to point out that the proposed regulations would not prohibit -- nor in any way penalize -- partial bids. The regulations would only ensure that the choice of a target's shareholders to sell a controlling interest in their company would be an undistorted one.

Now, I have already expressed my view that the social desirability of enabling partial acquisitions has been overstated, and that the efficiency gains that partial acqusitions produce are quite limited.117/ Nonetheless, as long as we can ensure undistorted choice without barring or penalizing partial bids, it would be desirable to allow bidders to make such bids. And it is thus a virtue of the proposed regulations that they would do exactly that.

Under the proposed regulations, bidders would be free to set any limit they wish on the amount of shares that they would acquire. A bidder seeking to purchase a non-controlling block would of course be exempt from the proposed regulations. And a bidder seeking to purchase a controlling interest would be free to determine the size of the controlling interest that it would seek. The regulations would only: (i) require the bidder to attract the required number of approving tenders; and (ii) ensure that all shareholders would be able to have the same fraction of their shares acquired for the bid's price or something close to it.

Consequently, the proposed regulation would not prevent any socially beneficial partial acquistions from taking place. Under the proposed regulations, the bidder would fail only if a majority of the target's shareholders view the expected acquisition price (the appropriately weighted average of the bid's price and the expected post-takeover value of minority shares) as lower

---

117/ *See* the discussion in *supra* note 85.

than the independent target's per share value. And in such a case the bid's failure would indeed be socially desirable.

Conversely, under the proposed regulations bidders would make partial bids whenever a partial acquisition would be more efficient than a complete acquisition. When a partial acquisition would be more efficient, the bidder would be able to offer a higher expected per share acquisition price in a partial bid than in a bid for all shares; consequently, since under the proposed regulations the bid's success would depend on the offered acquisition price, the bidder would elect in such a case to make a partial bid.

5. The Proposed Regulations and Shareholders' Freedom to Sell Their Shares

The free transferrability of shares is one of the important features of the modern public corporation. I wish therefore to examine the extent to which the proposed regulations would restrict shareholders' freedom to sell their shares. As I shall point out, the restrictions on alienation that the proposed regulations would involve are both quite limited and, more importantly, quite justified.

The only part of the proposed regulations that might involve restrictions on alienation is the one which would prohibit the bidder from purchasing a controlling interest in case it would not attract the required number of approving tenders.118/ For the concreteness of the discussion below, let us suppose that the controlling interest threshold is specified at 25% of the target's shares; and that the required fraction of approving tenders is specified

118/ The other elements of the proposed regulations would enable tendering shareholders to specify the conditions under which they would be willing to have their shares acquired, and would enable non-tendering shareholders to secure something close to their prorata share of the acquisition price. Whatever the merits of these rules, they would involve no restrictions on alienation.

at 50% of the target's shares. As will be presently seen, the only situation in which the considered rule would actually involve a restriction on alienation is when the shareholders who make approving tenders constitute more than 25%, but less than 50%, of the target's shareholders.

Suppose first that more than 50% of the target's shareholders make approving tenders. In this case, the regulations would allow the bidder to purchase as many shares as it wishes; the regulations would only require the bidder (in case the bid is partial) to enable all the shareholders to have the same fraction of their shares acquired for the bid's price. Note that in the considered case, the majority would be practically forcing those who make disapproving tenders to sell their shares. Of course, the proposed regulations would enable the shareholders who make disapproving tenders to get their prorata share of the acquisition price; and given that a takeover is going to take place, these shareholders would definitely prefer to have their shares acquired than to have them become minority shares. But these shareholders would most of all prefer to retain shares in the independent target, an option which would be ruled out for them by the majority's decisions. Thus, in the considered case, the majority would have the freedom to sell their shares, while the minority would have to give up its wish to continue the target's independent existence.

Suppose now that less than 25% of the target's shareholders make approving tenders. Again, the regulations would not impose any restrictions on alienation. To be sure, the bidder would not be able to purchase a controlling interest. But, then, the very fact that less than 25% of the shareholders have made approving tenders implies that there is no group of shareholders who among themselves hold the sought controlling interest and who would wish to enable the bidder to acquire it.

Thus, the proposed regulations would limit shareholders' freedom to sell their shares only in case that the fraction of shareholders making approving tenders is higher than 25% but lower than 50%. Hence, it would be possible to eliminate any restrictions on alienation by modifying the proposed regulations to allow a bidder to purchase a controlling interest whenever 25% or more of the shareholders make approving tenders. In my view, however, such a modification would be undesirable, as it would enable a bidder to gain control whenever 25% of the shareholders (rather than a majority) view the expected acquisition price as appropriate. As I explain below, when approving tenders are made by shareholders constituting between 25% and 50% of the target's shareholders, limiting the bidder's purchases to less than 25% of the shares is quite warranted.

Let us recall the already emphasized distinction between the acquisition of a non-controlling block and the acquisition of a controlling one.[119/] When a buyer purchases a non-controlling block of shares from a single shareholder or a group of shareholders, all that happens is that some shares change hands: the acquisition does not change the nature of the target's ownership or the allocation of its assets, nor does it affect the position of non-selling shareholders. In such a case, the selling shareholders' wish to sell their shares in no way conflicts with the wish of the non-selling shareholders to retain shares in an independent target. The two groups can both have their way.

Thus, when a buyer seeks to acquire a non-controlling block, the case for a freedom of transfer is compelling. There is no reason to prevent a sale by a willing seller to a willing buyer when the sale does not adversely affect the position of non-selling shareholders (or some other third parties). The

---

119/ *See* Part III, Subsection B.2.

freedom of the selling shareholders to sell their shares does not conflict with the other shareholders' wish to retain shares in an independent target.

Now, the consequences of an acquisition of a controlling interest are quite different from those of an acquisition of a non-controlling block. An acquisition of a controlling block transforms the independent target into a company with a controlling shareholder, and is likely to affect the way in which the target is run and the allocation of the target's assets. The acquisition affects not only the position of the selling shareholders but also that of non-selling shareholders: these latter shareholders will find themselves holding shares not in the independent target but rather in a company controlled by the bidder.

With this understanding of the consequences of an acquisition of a controlling interest, consider a case in which 40% of the target's shareholders respond to a bid by making approving tenders while 60% of the shareholders make disapproving tenders. Thus, 40% of the shareholders would like the bidder to acquire a controlling interest (and would be willing to contribute their shares for that purpose), while 60% of the shareholders would like the target to remain independent.

The difference between the two groups of shareholders is in their opinions -- in their judgments as to how the expected acquisition price compares with the independent target's value. For whatever the bid's outcome, the proposed regulations would ensure that all shareholders would share it equally. The shareholders in the minority group, however, view the expected acquisition price as higher than the independent target's value, while the shareholders in the majority group hold the contrary view. The two groups of shareholders differ, then, in their judgment as to which outcome of the bid would maximize the collective wealth of the target's shareholders.

It is clear that the two groups cannot both have their way. The wish of the minority group to sell a controlling block to the bidder is incompatible with the wish of the majority group to retain shares in an independent target. Of course, prohibiting the bidder from purchasing a controlling interest would limit the freedom of the minority group shareholders to sell their shares; such a prohibition would force upon these shareholders the majority opinion that the offered acquisition price is too low. But, it is equally clear, allowing the bidder to purchase a controlling interest would be to force the minority opinion on the majority. To be sure, if the bidder is allowed to gain control and a takeover takes place, the shareholders in the majority group will all receive their prorata share of the acquisition price; but these shareholders view this prorata share as lower than the value of their shares in the independent target, and they would prefer to continue to hold such shares.

Which group's opinions and wishes should the law follow? According to the proposed undistorted choice objective, we should follow the judgment of the majority. As I shall explain in Part VI, the reason for this is one of efficiency: the majority is more likely than the minority to be correct in its assessment as to how the expected acquisition price compares with the independent target's value.

Thus, when a majority of the shareholders make approving tenders (or vote in favor of a merger proposal) we should allow the bidder to gain control; and we should accept that the acquisition will practically force the shareholders who make disapproving tenders to sell their shares. When only a minority of the shareholders make approving tenders, however, we should not allow the bidder to gain control. We should not enable the minority in this case to prevail upon the majority by appealing to an alleged freedom to sell; we should do so for the same reason that we should not allow a merger to take place if only a minority of the shareholders have voted in its favor.

## D. Comparison to the British Arrangements

In Britain, takeovers are subject to both governmental regulation and industry self-regulation. The main body of takeover rules is the City Code on Take-Overs and Mergers, which was drafted (and is administered and enforced) by the Panel on Take-Overs and Mergers, a non-governmental entity that functions under the auspices of the Council for the Securities Industry.[120/]

This Section describes some of the British rules and compares them to the regulations that I put forward. The British rules that I shall consider appear to have been at least partly motivated by similar concerns to those which motivate the present inquiry; and they bear substantial similarity to the regulations that I propose. The British rules, however, do not seem to have been drafted with a complete and systematic understanding of the distorted choice and unequal treatment problems, and of how these problems can be adequately addressed. Consequently, as will be seen, the British rules go too far in some respects, and not far enough in others.

### 1. The Determination of a Bid's Success

Under the proposed regulations tendering shareholders would be able to tender either approvingly or disapprovingly, and a bidder would be prohibited from purchasing a controlling interest unless it would receive a majority of approving tenders. As I demonstrated, this rule would ensure that a target would be taken over if and only if a majority of the shareholders prefer the

---

120/ For a general discussion of the City Code and of the Panel on Take-Overs and Mergers, see A. Johnston, The City Take-Over Code (1980); DeMott, Current Issues in Tender Offer Regulation: Lessons from the British, 58 N.Y.U.L. Rev. 945 (1983).

target to be taken over. This proposed rule should be compared with two British arrangements, one applying only to partial bids and the other applying to all bids.

a. The Approval Requirement in Partial Bids

The City Code discourages and restricts partial bids, and partial bids are much less popular in the UK than they are in the US.[121/] When a partial bid is made, however, the City Code imposes an approval requirement which is very similar to the one that I propose for all bids. The Code requires a partial bid to be conditional upon the approval of a majority of the target's shareholders.[122/] Approval is signified by an entry in a separate box on the tender form, where a tendering shareholder can indicate whether or not he approves the partial bid. Thus, in the case of a partial bid, the City Code ensures that the bid will succeed if and only if a majority of the shareholders prefer a takeover to take place.

The problem with the British approval requirement, of course, is that it is limited to partial bids. The requirement's limited scope is presumably a result of the British belief that partial bids pose different and more serious problems than do bids for all shares. As I already explained, however, this belief, which is shared by many in the U.S., is mistaken. The British approach to partial bids, explains a leading British treatise, is motivated by "the realization that British company law provides inadequate remedies for minority shareholders who feel that those in control of a company are abusing their position".[123/] As the analysis of this Article has demonstrated, however, the

---

121/ See Subsection 4 of this Section.

122/ The City Code, supra note 104, rule 27.

123/ M. Weinberg & M. Blank, Weinberg and Blank on Take-Overs and Mergers (4th ed., 1979), at 115. See also Johnston, supra note 120, at 254.

ability of an acquirer to take advantage of minority shareholders gives rise to choice distortions which are present in all bids, whether partial or for all shares.

Needless to say, the British approval requirement, being limited to partial bids, does not address the problem of distorted choice in bids for all shares, bids which constitute the majority of bids in Britain. Indeed, the requirement leads bidders to make bids for all shares even if a partial acquisition is the transaction's most efficient form. In sum, as long as the British approval requirement is limited to partial bids, it would be incapable of making a substantial contribution to addressing the distorted choice problem.

b. Providing a Second Opportunity to Tender

According to the City Code, a bidder is prohibited from purchasing any tendered shares unless it has received tenders from a majority of the target's shareholders.[124/] Thus, in the case of a bid for all shares, attracting a majority of tenders is both a necessary and a sufficient condition for a takeover. Requiring bidders to attract a majority of tenders obviously cannot by itself ensure an undistorted choice. The City Code, however, includes a rule that might seem to work in that direction. The Code requires a bidder that succeeds in attracting the necessary majority to leave its offer open for an additional two weeks.[125/] This "second round" gives non-tendering shareholders, once it becomes clear that a takeover is going to take place, a second opportunity to tender and receive the same treatment as all tendering shareholders. This rule of the City Code seems to contribute to attaining undistorted choice

---

124/ See The City Code, supra note 104, Rule 21. For simplicity I am assuming here that the bidder holds no shares in the target.

125/ See The City Code, supra note 104, Rule 23.

because it enables shareholders who prefer the bid to fail to safely hold out, knowing that in case the bid succeeds they will receive a second opportunity to tender.

Presently I shall point out that a rule providing a second opportunity to tender is not the right way to address the distorted choice problem. But I wish first to note that the drafters of the British rule do not appear to have aimed at addressing the distorted choice problem or to have had a systematic understanding of this problem. The rule allows a successful bidder to deny shareholders a second opportunity to tender (exercise a "shut-off") if the bidder has given the shareholders a two-week advance notice that no second opportunity to tender would be provided.[126/] It is easy to see that a rule seeking to ensure undistorted choice should not allow bidders to exempt themselves from the rule's application by giving shareholders an advance notice. Notifying shareholders that they will not have a second opportunity to tender would not protect them from the pressure to tender; much the same way that giving to an individual an advance notice that a gun will be pointed to his head the next day would not enable the individual to make an undistorted choice on that next day when (as notified) the gun will be pointed to his head.

In any event, even supposing that the rule providing a second opportunity to tender does not enable bidders to exercise a "shut-off", the British rule is not the right way to address the distorted choice problem. To be sure, under the rule shareholders who prefer the bid to fail will not tender. The problem is, however, that shareholders who prefer the bid to succeed might not bother to tender either. Thus, the outcome of bids is still distorted under the rule, but this time against bidders: a bid might well fail even if a majority of the shareholders prefer it to succeed.

---

126/ *Ibid*.

To see this, consider the tender decision of a shareholder who prefers the target to be taken over. Supposing that the bid is going to succeed regardless of the shareholder's decision, his tender decision will not matter, as shareholders who tender in the "first round" and in the "second round" will all receive the same treatment. And supposing that the bid is going to fail regardless of his decision, the shareholder will be somewhat better off holding out: as the City Code requires failing bidders to return all tendered shares, tendering will only involve wasteful transaction costs. Consequently, the shareholder might elect to hold out and save the transaction costs involved in tendering. To be sure, supposing that the shareholder's decision is going to determine the bid's fate, he will be better off tendering and bringing about a takeover, which is his preferred outcome. But since the likelihood that his decision will prove pivotal is small, the shareholder might well hold out even though he prefers the bid to succeed.

The problem with the rule providing shareholders with a second opportunity to tender might be alternatively described as follows. Establishing a "second round" essentially turns the "first round" into the equivalent of an approval vote, as each shareholder's initial tender decision matters only in case that the decision proves pivotal. A shareholder wishing to express a preference for the bid's success has to tender his shares in the "first round", while one wishing to express a preference for the bid's failure has to hold out in that round. The problem is that expressing a preference for the bid's success involves extra transaction costs in comparison to expressing a preference for the bid's failure. This transaction costs differential creates a substantial bias against tendering and expressing a preference for the bid's success.

It might be worthwhile recalling how the arrangement that I propose would avoid the above problem. Under the proposed regulations, shareholders would express their approval or disapproval of a takeover in conjunction with the tendering of shares. Their choice between tendering approvingly and disapprovingly would involve no transaction costs differential, and would therefore be solely determined by their preferences concerning the bid's outcome.127/

2. The Treatment of Tendering Shareholders in Case the Bid Fails

Thus far I have examined the British rules that determine a bidder's success in gaining control. I now turn to examine the British rules concerning the treatment of tendering shareholders by a failing bidder. Under the City Code, a failing bidder cannot buy any tendered shares, and must return all tendered shares to tenderors.128/

In contrast, under the regulations that I propose, a failing bidder might use its bid to purchase a non-controlling block. The bidder might purchase shares of tendering shareholders who specifically indicated their willingness to have their shares acquired even in case that the bid fails.

The proposed regulations, I believe, take a somewhat preferrable approach to the one of the City Code. If some shareholders are willing to sell their shares to the failing bidder then there is no reason to prohibit this transaction, provided that the bidder is limited to purchasing a non-controlling block and that the shareholders specifically indicated their willingness to engage in the transaction. To be sure, a British bidder that fails to gain control may make a subsequent bid aimed at, and limited to, the purchase of a non-controlling block. But the approach that I suggest would save the transaction costs that such an additional bid would involve.

127/ It might also be worthwhile recalling that the problem considered above played a role in the design of the proposed regulations concerning non-tendering shareholders. In order to ensure that shareholders who are aware of the bid would tender, the proposed regulations would provide non-tendering shareholders not with exactly their prorata share of the acquisition price but with something less than that.

128/ *See* The City Code, *supra* note 104, Rule 21.

3. The Treatment of Non-Tendering Shareholders in Successful Bids

The regulations that I propose with respect to non-tendering shareholders in successful bids would enable such shareholders to secure something close to their prorata share of the acquisition price. As was explained, this would be desirable not only from the perspective of equal treatment, but also from that of undistorted choice. The proposed regulations would include two elements: one that would regulate the terms of immediate takeouts, and one that would provide redemption rights in case an immediate takeout would not occur.

Let us now turn to examine the British treatment of non-tendering shareholders, and let us first consider the issue of immediate takeouts. In Britain, a bidder that succeeds in gaining control is often able to effect, in one of several alternative ways, a compulsory acquisition of the outstanding minority shares.129/ Consequently, immediate takeouts do occur in the U.K., though it is generally more difficult to effect a takeout in Britian than in the U.S.130/ When a British successful bidder does effect a takeout, the bidder generally has to pay a takeout consideration with terms equal to the bid's consideration.131/

---

129/ The bidder might be able to make a compulsory acquisition of minority shares by using Section 209 (1) of the 1948 Companies Act; or by effecting a scheme of rearrangement pursuant to section 206 of the Companies Act; or by following a certain procedure to reduce the target's capital; or, finally, by altering the articles of association to permit expropriation of minority shares. See M. Weinberg & M. Blank, supra note 123, Ch. 8.

130/ For example, section 209(1) requires the bidder to have received tenders from at least three-fourths in number of the shareholders, totalling at least 90% of the target's shares.

131/ Section 209(1) of the 1948 Companies Act specifically requires that in a compulsory acquisition pursuant to that Section the bidder must provide minority shareholders with the bid's terms. See Re Carlton Holdings Ltd. (1971) 1 W.L.R. 918. The other procedures to effect a takeout either require a court approval of the terms' fairness or are subject to court intervention, and there appear to be no cases where following a takeover the bidder effected a takeout with a consideration lower than the bid's consideration.

Let us now turn to the treatment of non-tendering shareholders in the case that an immediate takeout does not take place. The regulations that I propose would provide such shareholders with redemption rights. Section 209(2) of the British Companies Act of 1948 establishes a similar arrangement in certain limited circumstances.132/ The situation to which the British rule is limited is one in which a successful bid has acquired more than 90% of the target's shares; in such a case, minority shareholders have the option to redeem their shares for the bid's price within four months following the takeover.

The problem with the British rule is that it limits redemption rights to the case where following the takeover minority shares constitute less than 10% of the target's shares. The analysis which suggests that redemption rights are desirable on grounds of both equal treatment and undistorted choice, however, provides no reason whatsoever to impose the above limitation.133/ It would be desirable to provide redemption rights in all takeovers, and a successful bidder would often acquire through its bid less than 90% of the target's shares.134/

---

132/ See M. Weinberg & M. Blank, supra note 123, at pp. 361-66.

133/ A British Committee (The Jenkins Committee) considered abolishing the limitation, but rejected this possibility. The Committee said that abolishing the limitation would have the effect of turning every partial bid into a bid for all shares. See M. Weinberg & M. Blank, supra note 123, at pp. 365-66. As I have explained, however, the proposed regulations concerning redemption rights would not require a bidder that makes a partial bid to purchase more than the specified fraction of shares that the bidder seeks. See Subsection A.2 of this Part.

134/ In connection with the provision of redemption rights, it is also worthwhile noting an already mentioned British rule, viz., the one that requires successful bidders (which did not exercise a "shut-off") to leave their successful bid open for an extra two weeks. See Subsection D.1.b. I have already suggested that the rule distorts bids' outcomes against bidders. The rule, I wish also to point out, does not ensure that all shareholders will be able to secure their prorata share of the acquisition price. For the fact that the option is open only for two weeks, and that shareholders are not notified about it means that some shareholders are unable to take advantage of it. In contrast, the regulations that I propose would ensure that all non-tendering shareholders would have the opportunity to take advantage of their redemption rights.

4. The Treatment of Partial Bids

The City Code's implicit view concerning partial bids is that they are of questionable desirability.[135/] The Code's drafters seem to have been of the opinion that partial bids pose different and more serious problems than do bids for all shares. Consequently, the Code discourages partial bids. As already noted, for a partial bid to succeed it has to be approved by a majority of the shareholders while a bid for all shares does not face such a requirement. Moreover, every partial bid requires the consent of the Panel on Take-Overs and Mergers.[136/] And while the Panel frequently grants consent to bids for more than 50% of the target's shares, it gives consent only in exceptional circumstances to bids for more than 30% but less than 50%.[137/]

As the analysis has demonstrated, however, the problems posed by partial bids and bids for all shares are essentially the same;[138/] and, as long as target shareholders make an undistorted choice, bidders should be free to choose the kind of offer they make. Consequently, the proposed regulatory framework would apply essentially the same rules to partial bids and to bids for all shares. Hence, under the proposed regulations, bidders would make partial bids whenever a partial acquisition is the transaction's most efficient form. As I noted, in my view the gains from allowing partial acquisitions are likely to be limited.[139/] Still, there are some cases where a partial acquisition

---

135/ Early versions of the Code even prefaced the provisions governing partial bids with the statement that such bids are undesirable. In 1974, however, this statement was deleted and the Code moved to a more ambiguous position. *See* A. Johnston, *supra* note 120, at 254.

136/ The City Code, *supra* note 104, Rule 27.

137/ See The City Code, *supra* note 104, Rule 27; M. Weinberg & M. Blank, *supra* note 123, at 157-167.

138/ *See* Part IV, Section A.

139/ *See* the discussion in *supra* note 85.

is more efficient than a complete acquisition. Therefore, it is an advantage of the proposed regulations (vis-a-vis the British rules) that they would not prohibit or penalize partial bids.

# VI. THE DESIRABILITY OF UNDISTORTED CHOICE AND EQUAL TREATMENT

Thus far I have explained (i) how far we currently are from attaining the objectives of undistorted choice and equal treatment, and (ii) what regulatory reforms would be necessary to attain these two objectives. I still owe the reader, however, a systematic and detailed explanation as to why these two objectives are in my view both desirable and important. This task I undertake in this Part.

## A. Undistorted Choice

### 1. The General Point

It is in society's interest that corporate assets (as well as any other resources) will be allocated to their most valuable and productive uses. The productiveness of given assets might well depend on the identity of the corporation that controls them; for the controlling corporation's identity will determine the managerial resources that will be brought to bear upon the assets, and the other resources in combination with which the assets will be operated. Consequently, there are likely to be at any time some companies whose acquisition by other companies would produce social gains. An acquisition might produce gains, for example, by improving the target's management or by creating "synergy."

The problem with which the Article is concerned is choosing the mechanism that will determine whether a given company will be acquired, and, if so, by which potential acquirer. While the acquisition of some companies might well produce social gains, there are many other companies for which remaining independent will be the most efficient course of action. And where the acquisition of a company is likely to produce social gains, the amount of these gains might well depend on the acquirer's identity; the magnitude of synergistic gains clearly depends on the "fit" between the acquirer and the target, and acquirers might also differ in their ability to improve the target's management. For these reasons the choice of the mechanism that will determine the outcome of acquisition offers is an important choice. We should seek the mechanism that would be most likely to ensure an efficient allocation of corporate assets.

Consider for a moment the sole owner context. Again, a sole owner's assets might be more valuable to some other parties. The law generally prescribes that another party will be able to acquire these assets if and only if that party gets the owner's consent. Economic theory suggests that this mechanism is one which does a generally good job in allocating resources efficiently. The self-interested owner will sell his assets if and only if he views the offered acquisition price -- which reflects the assets' value to the potential buyer -- as higher than other available offers and than the value to himself of retaining the assets (including the prospect of receiving higher offers in the future).

To be sure, the above mechanism does not ensure that sole owners' assets will be efficiently allocated in every instance. For example, a sole owner might make a mistake (in both directions) in estimating the value to himself of retaining his assets. But this mechanism, though imperfect, might well be the best we can design; certainly it is superior to one which would allow a potential buyer to take a sole owner's assets without the owner's consent, provided only that the buyer pay the owner the assets' appraised market value prior to the taking. While a sole owner might make mistakes, the considerations that shape his decision are those which from the point of view of efficiency are the relevant ones: how does the offered acquisition price (which reflects the assets' value to the potential buyer) compare with the value to the owner of retaining his assets?

Let us now return to the context of the public corporation. According to the undistorted choice objective, the guiding principle in this context should be similar to the one that we follow in the sole owner context: a company should be acquired if and only if its owners, the shareholders, view the offered acquisition price as higher than the independent target's value (including the prospect of receiving other offers in the future). Let us for the present suppose that the shareholders all share the same judgment as to how the offered acquisition price compares with the independent target's value -- I shall a bit later (Subsection 3) examine the question of what is the desirable outcome when the shareholders' judgments diverge.

As in the sole owner context, ensuring undistorted choice would not assure an efficient allocation of targets' assets in every single instance. Target shareholders might make mistakes, much the same way that sole owners do, in estimating both the independent target's value and the offered acquisition price. But ensuring undistorted choice, I submit, is the best mechanism that we can employ to determine the allocation of target assets, at least as long as we limit ourselves to private market solutions.

There might be some who would question that part of the objective which suggests that a bid should fail whenever the target's shareholders view the offered acquisition price as lower than the independent target's value. They would argue that whenever the offered per share acquisition price exceeds the pre-bid market price of the target's shares, an acquisition is socially desirable. On their view, the pre-bid market price best reflects the independent target's per share value; in particular, the pre-bid market price reflects this value better than do the shareholders' estimates of it at the time of their tender decisions. Consequently, they argue, when the offered per share acquisition price exceeds the pre-bid market price, then an acquisition is socially desirable even if the shareholders view the independent target's per share value as higher than the offered per share acquisition price.

The above view is mistaken, however. Shareholders' estimates (at the time of their tender decisions) of the independent target's per share value are likely to offer better measures of this value than does the pre-bid market price of the target's shares. However limited the shareholders' information, they are presumably aware of the pre-bid market price, and hence will not adopt a different, higher estimate of the independent target's per share value unless they have reasons for doing that. What reasons might they have? The takeover process often leads investors to revise their valuation of the target's independent value. The shareholders, for example, might derive information about the target's value from the very fact that a bid was made, or might receive from the incumbent management some new information about that value. Thus, whenever a target's shareholders view rejection of a premium bid as value-maximizing, the target should remain independent. Again, the shareholders might be making a mistake. But efficiency is more likely to be served by following their judgment than by going against it.

Finally, I wish to point out that undistorted choice by target shareholders would contribute not only to _efficient allocation_ of target assets, but also to _efficient pricing_ of targets. To induce a socially optimal level of investment in a given project, investors must be able to capture the social gains resulting from their investment. Now, undistorted choice by target shareholders would secure that a bidder would not be able to acquire a target for less than the competitive price. Consequently, shareholders of potential targets would expect to receive those social gains that are attributable to the existence of their companies. And this would move us towards inducing efficient levels of investment in potential targets.[140/]

---

140/ See Bebchuk, _supra_ note 20, at 42-44.

2. The Importance of Ensuring that Shareholder Support be a Necessary Condition

The undistorted choice objective can be divided into two elements: first, ensuring that shareholder support be a necessary condition for a takeover; and, second, ensuring that shareholder support be a sufficient condition for a takeover. Most of the Article, however, has focussed on the objective's first element. And I therefore wish now to discuss the importance of this element.

Now, the preceding general discussion has made clear that whenever a target's shareholders view rejecting a bid as the value-maximizing course of action, the bid should indeed fail; thus, ensuring that shareholder support be necessary for a takeover is socially desirable. But the preceding general discussion did not establish -- and hence it remains to be shown -- that this element of the undistorted choice objective is an important one. The question is how frequently does it happen that a target's shareholders judge rejection of a bid to be their value-maximizing course of action. I therefore wish to point out now that this is not a theoretical possibility but rather one that is likely to occur in a significant number of instances.

To start with, the shareholders might view a rejection of a given bid as value-maximizing due to the presence of another available bid which they judge to offer a higher expected acquisition price. While one might initially doubt that rejecting a premium bid in order to remain independent might ever be value-maximizing, no one will question that rejecting a bid in favor of a higher rival bid will be value-maximizing. As the Appendix demonstrates, the current distortions inflict not only shareholders' choice between selling their company and remaining independent, but also their choice between rival bids. Consequently, in current bidding contests a bidder might gain control even though another bidder, which can put the target's assets to a more valuable use, is offering a higher acquisition price. Thus, enabling shareholders to make an undistorted choice among competing offers -- which, as the Appendix shows, the proposed regulations would do -- is necessary for securing an efficient allocation in the many instances of current bidding contests.

More importantly, there is a substantial number of cases, I suggest, where the shareholders' value-maximizing course of actions is to reject all available bids. In these cases, the rejection of a given bid is desirable not due to the presence of a available higher offer, but because the shareholders' value-maximizing course of action is to remain independent, at least for the time being.

No one would of course doubt that a sole owner might find it in his interest to reject the acquisition offer(s) made to him at some point in time and retain his assets, at least temporarily. But some might doubt that a target's shareholders will ever view remaining independent as value-maximizing. The reason for holding such a view is that takeover bids commonly offer a significant premium above the target's pre-bid market price; and this market price is supposed to reflect investors' valuation of the target. This reasoning, however, ignores the already noted fact that the takeover process might well change investors' valuations of the target.[141/] It is thus quite possible that at the time when the shareholders make their tender decisions, their estimates of the target's independent value (including the prospect of receiving higher bids in the future) will be higher than their pre-bid estimates.

It is worthwhile recalling at this stage the empirical findings of Professors Bradley, Desai, and Kim.[142/] These researchers found a non-trivial

---

141/ *See* Grossman & Hart, The Allocational Role of Takeover Bids in Situations of Asymmetric Information, 36 *J. Fin*. 353 (1981)

142/ *See* Bradley, Desai, & Kim, *supra* note 49.

number of cases where a target's shareholders, in spite of the current distortions, rejected all available bids and remained independent. In these cases remaining independent indeed turned out to be the value-maximizing course of action: following the bids' failure, the market price of the target's shares was higher than the bid's price, and in most of these cases the target was acquired through a higher bid within a year or two. Thus, the theoretical possibility that remaining independent will be the value-maximizing course of action is quite real. Note that, as the Article's analysis has shown, the current distortions are quite substantial, and consequently a bid is likely to fail only if the expected acquisition price exceeds the independent target's value by a wide margin; most of the instances identified by Bradley, Desai, and Kim presumably belong to this category. It is thus reasonable to suspect that there is currently a significant number of cases where remaining independent is value-maximizing, but not by a sufficiently wide margin to overcome the current distortions.

Now, there are several reasons why a target's shareholders might judge remaining independent to be their value-maximizing course of action. First, the shareholders might expect that another bidder, who can put the assets to a more valuable use than can the present bidder, will come forward later on with a higher bid. As just noted, existing empirical evidence indicates that this might be a quite real possibility. To be sure, the Williams Act prescribes a delay period, which often enables competing bidders to come forward before shareholders have to make irrevocable decisions concerning the initial bid.143/ But the required delay period might in many instances fall short of the time necessary for a given competing bid to materialize. And, as it is desirable to resolve a bid's fate quickly, it would be undesirable to adopt a very

143/ 15 U.S.C. §78 n(d)(5)(1976). See Bebchuk, supra note 7, at 1051-54.

lengthy uniform delay period. Enabling an undistorted choice by target shareholders would provide them with the necessary flexibility: the required uniform delay period would remain quite limited, but when a further delay would seem beneficial, the shareholders would be able to freely choose to remain independent for the time being.

Second, the shareholders might judge the current bidder to be the highest-valuing user of the target's assets, but expect that rejection of the present bid would lead the present bidder to make a higher bid. The current distortions of shareholder choice might enable a bidder to acquire a target for less than the competitive price -- that is, the price that other potential acquirers would be willing to pay for the target. The threat of competing bids might be insufficient to secure a competitive price, because the competition in the market for corporate acquisitions is far from perfect. In particular, if the current bidder is viewed as the one that places the highest value on the target, other potential buyers will not enter a costly bidding contest -- which they are bound to lose -- even if the current bid is lower than the competitive price.[144/] Enabling a target's shareholders to exercise an undistorted choice, however, would ensure that a target would not be acquired for less than the competitive price, and would thus contribute to the efficient pricing of potential targets.[145/]

Third, the shareholders might believe that the bidder's reason for making the bid was that the target's shares were undervalued by the market, and the

---

144/ See Bebchuk, supra note 7, at 1036, n. 45.

145/ Note that this efficient pricing would not usually be accomplished through the rejection and subsequent increase of bids; rather, once the current distortions are eliminated, bidders would take into account the shareholders' ability to exercise an undistorted choice and would adjust their initial bids upwards towards the competitive price.

shareholders might judge the offered acquisition price to be lower than the target's true value. While undervaluation by the market is unlikely to be the dominant motive for takeover bids, it might well be the motive in a non-trivial number of cases. The recent wave of takeovers of oil companies, for example, was widely regarded as motivated by the undervaluation of these companies' stock.[146]

Fourth, it might even be possible that a target's shareholders will be concerned that the bidder's offer is motivated by the prospect of "looting" -- that is, of diverting the target's earning to itself. For looting to be possible, the bidder's post-takeover gains from diverting earnings must exceed the premium paid to acquire a controlling majority. Consequently, as takeover bids commonly offer a considerable premium, the prospect of looting is unlikely to motivate bids in more than a small minority of cases. Nonetheless, it is desirable to completely rule out this possibility, and ensuring undistorted choice would accomplish that.

In sum, there is a strong theoretical and empirical basis for believing that there is currently a significant number of cases where, due to the current distortions, bids are accepted even though their rejection would be value-maximizing.

### 3. The Decisive Fraction

Thus far I have assumed that a given target's shareholders all share the same view as to how the offered acquisition price compares with the independent target's value. In such a case, the guiding principle is simple: the target should be taken over if and only if the shareholders view the former value as

---

146/ *See* Bebchuk, *supra* note 7, at 1032-33; Lowenstein, *supra* note 5, at 277.

higher than the latter. Shareholders, however, might differ in their estimates of the independent target's value and of the expected acquisition price. Suppose that some of them judge the former to be higher than the latter, while others hold the contrary view. Which view should we follow? According to the proposed undistorted choice objective, the decisive fraction, the fraction whose view should prevail, is that which includes a majority of the shareholders. That is, the target should be taken over if and only if a majority of the shareholders view the offered acquisition price as higher than the independent target's value. I wish now to explain the reasons for my choice of the decisive fraction, and also to point out that the Article's analysis will be wholly relevant even if one chooses to define the decisive fraction differently than I do.

The reason behind the proposed definition of the undistorted choice objective is as follows. From the point of view of efficiency, the desirable outcome of the bid depends on how the offered acquisition price compares with the independent target's value. And the majority's judgment concerning this issue is more likely to be correct than the minority's judgment. Therefore, efficiency is more likely to be served by following the majority's view than by following the minority's view.

Now, by a majority of the shareholders I have meant throughout shareholders who together hold a majority of shares. One might of course wonder why the undistorted choice objective should be defined in this way and not by reference to a numerical majority of the shareholders. The reason for this is that the greater the number of shares held by a shareholder, the greater his incentive to seek information about the target, and hence the more informed his judgment as to whether or not the offered acquisition price exceeds the independent target's value. Therefore, in aggregating shareholders' views, the weight attached to a shareholder's view should depend on the number of shares that he holds. Finding the optimal weighting formula is clearly very complicated, and it requires more information than is currently available concerning the connection between the size of a shareholder's block and the amount of information that he will gather. Consequently, defining the undistorted choice by reference to shareholders who together hold a majority of shares seems as (at least) the best definition to start with at this stage.

In any event, I wish to emphasize that the Article's analysis is wholly relevant to someone who would specify the decisive fraction differently than I do. First, in analyzing the current distorted choice, I have focussed on the fact that shareholders' tender decisions do not reflect their views as to how the offered acquisition price compares with the independent target's value; and this might lead to a distorted choice no matter how the decisive fraction is defined. Second, one who would define the decisive fraction differently than I do should still embrace the proposed regulations with only one modification: the different specification of the decisive fraction in the definition of undistorted choice would lead him to a different specification of the crucial fraction of approving tenders that the bidder would have to attract in order to gain control.

4. <u>The Social Costs of Ensuring Undistorted Choice</u>

Having shown that undistorted choice would contribute to efficient allocation of targets' assets, it still remains to consider whether ensuring undistorted choice would involve some prohibitive social costs. Below I therefore address this concern, and I point out that ensuring undistorted choice would in all likelihood involve no substantial social costs.

As was explained, ensuring an equal treatment is necessary to attaining undistorted choice. Consequently, in examining the social costs of ensuring undistorted choice I will also be examining the costs involved in ensuring higher than the latter. Shareholders, however, might differ in their estimates of the independent target's value and of the expected acquisition price. Suppose that some of them judge the former to be higher than the latter, while others hold the contrary view. Which view should we follow? According to the proposed undistorted choice objective, the decisive fraction, the fraction whose view should prevail, is that which includes a majority of the shareholders. That is, the target should be taken over if and only if a majority of the shareholders view the offered acquisition price as higher than the independent target's value. I wish now to explain the reasons for my choice of the decisive fraction, and also to point out that the Article's analysis will be wholly relevant even if one chooses to define the decisive fraction differently than I do.

The reason behind the proposed definition of the undistorted choice objective is as follows. From the point of view of efficiency, the desirable outcome of the bid depends on how the offered acquisition price compares with the independent target's value. And the majority's judgment concerning this issue is more likely to be correct than the minority's judgment. Therefore, efficiency is more likely to be served by following the majority's view than by following the minority's view.

Now, by a majority of the shareholders I have meant throughout shareholders who together hold a majority of shares. One might of course wonder why the undistorted choice objective should be defined in this way and not by reference to a numerical majority of the shareholders. The reason for this is that the greater the number of shares held by a shareholder, the greater his incentive to seek information about the target, and hence the more informed his judgment as to whether or not the offered acquisition price exceeds the independent target's value. Therefore, in aggregating shareholders' views, the weight attached to a shareholder's view should depend on the number of shares that he holds. Finding the optimal weighting formula is clearly very complicated, and it requires more information than is currently available concerning the connection between the size of a shareholder's block and the amount of information that he will gather. Consequently, defining the undistorted choice by reference to shareholders who together hold a majority of shares seems as (at least) the best definition to start with at this stage.

In any event, I wish to emphasize that the Article's analysis is wholly relevant to someone who would specify the decisive fraction differently than I do. First, in analyzing the current distorted choice, I have focussed on the fact that shareholders' tender decisions do not reflect their views as to how the offered acquisition price compares with the independent target's value; and this might lead to a distorted choice no matter how the decisive fraction is defined. Second, one who would define the decisive fraction differently than I do should still embrace the proposed regulations with only one modification: the different specification of the decisive fraction in the definition of undistorted choice would lead him to a different specification of the crucial fraction of approving tenders that the bidder would have to attract in order to gain control.

### 4. <u>The Social Costs of Ensuring Undistorted Choice</u>

Having shown that undistorted choice would contribute to efficient allocation of targets' assets, it still remains to consider whether ensuring undistorted choice would involve some prohibitive social costs. Below I therefore address this concern, and I point out that ensuring undistorted choice would in all likelihood involve no substantial social costs.

As was explained, ensuring an equal treatment is necessary to attaining undistorted choice. Consequently, in examining the social costs of ensuring undistorted choice I will also be examining the costs involved in ensuring equal treatment. Therefore, there will be no reason later to have a separate discussion of the costs of ensuring equal treatment: the conclusion that attaining the undistorted choice objective would involve no substantial social costs will apply also to attaining the equal treatment objective.

The costs that I shall examine, I wish to emphasize, are social costs. Ensuring undistorted choice would involve substantial losses to some private parties. Bidders, for example, would have to pay higher prices for acquired targets. But this loss to bidders would by itself represent not a social loss, but rather a transfer of wealth from bidders' shareholders to targets' shareholders. The higher prices that bidders would have to pay are relevant from a social point of view only if these higher prices would lead bidders or would-be bidders to change their behavior inefficiently.

Hence, to examine whether ensuring undistorted choice would involve substantial social costs, I shall consider below the various socially beneficial activities that prospective buyers, arbitrageurs, and sophisticated investors undertake. And I shall examine whether ensuring undistorted choice would have a substantial adverse effect on any one of these activities.

a. Search for Potential Targets

Let us first consider the concern that ensuring undistorted choice would have a substantial adverse effect on search by prospective buyers for potential targets. Professors Easterbrook and Fischel, in two articles, have emphasized that for the corporate acquisitions market to operate efficiently, it is necessary to provide prospective buyers with incentive to invest in search for potential targets.147/ Easterbrook and Fischel's view is that to encourage

---

147/ See Easterbrook & Fischel, supra note 1; Easterbrook & Fischel, Auctions and Sunk costs, 35 Stan.L.Rev. 1 (1982). See also Grossman & Hart, Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation, 11 Bell J. Econ. 42 (1980).

search for potential targets we should seek to maximize searchers' returns, and to this end we should seek to minimize the premium that is necessary to acquire a discovered target. On this view, ensuring undistorted choice would be undesirable since it would increase takeover premiums.

The considered concern does not provide a basis for opposing the undistorted choice objective. As I have explained elsewhere,[148/] curtailing takeover premiums is not necessary in order to induce an adequate level of search. Competitive acquisition prices are quite consistent with providing searchers with substantial rewards (relative to search costs). For example, searchers can make substantial profits, and often do, on pre-bid purchases of the stock of targets that they discover.[149/] Consequently, the need to provide incentives to search for potential targets does not require distorting the choices of discovered targets' shareholders -- that is, it does not justify abandoning the undistorted choice objective.

b. Beneficial Acquisitions of Discovered Targets

Having seen that ensuring undistorted choice would not have a significant adverse effect on search for potential targets, let us now consider whether it might prevent some beneficial acquisitions of identified targets. Easterbrook and Fischel suggested that the current pressure to tender might be necessary for bids to succeed.[150/] If such a pressure did not exist, they warned, shareholders would have a strong incentive to hold out; consequently, socially beneficial acquisitions would be prevented.

---

148/ *See* Bebchuk, *supra* note 7, at 1034-38; (1982); Bebchuk, *supra* note 20, at 31-33.

149/ *See* Bebchuk, *supra* note 7, at 1035.

150/ *See* Easterbrook & Fischel, *supra* note 22. *See also* Grossman & Hart, *supra* note 147.

The above concern is not justified. As I have shown, it is quite possible to eliminate the current pressure to tender without sacrificing any beneficial acquisitions. Under the proposed regulations, the only acquisition attempts that would be prevented from succeeding are those that indeed should fail -- those where (in the view of a majority of the target's shareholders) the independent target's value exceeds the offered acquisition price.

c. Information Seeking by Sophisticated Investors

Let us now examine whether the current unequal treatment is necessary to reward sophisticated investors for socially beneficial activities that they undertake in response to takeover bids.[151/] I wish first to consider those sophisticated investors that were shareholders of a given target when the bid was made; I shall a bit later consider arbitrageurs, who buy target shares subsequent to the bid's announcement.

When a takeover bid currently succeeds, shareholders who were unaware of the bid or who did not tender due to their hope that the bid would fail end up with considerably less than their prorata share of the acquisition price. Conversely, shareholders who were aware of the bid and correctly estimated that it would succeed end up with more than their prorata share. Sophisticated investors, who have good information about available bids and about their expected outcome, are disproportionately represented in this latter group of shareholders who end up with more than their prorata share. Hence, one might be concerned that ensuring undistorted choice would eliminate sophisticated investors' incentives to seek information about available bids and about their expected outcome.

---

151/ This possibility was alluded to by the SEC's Advisory Committee. See Advisory Committee Report, supra note 10, at 52.

Again, this concern cannot justify opposing the undistorted choice objective. Consider first the issue of shareholders' incentive to learn about available bids. The proposed regulations would leave investors with a strong incentive to learn whether a bid has been made for a company in which they own stock. Under the proposed regulations, shareholders who are unaware of a bid and hence do not tender would lose three-months-interest in case the bid is successful; and while this penalty seems to me quite sufficient, it might be somewhat increased if one seeks to further penalize shareholders' ignorance of bids. Thus, under the proposed regulations, the great majority of potential target shareholders would continue to seek information as to whether there are bids for their companies. To be sure, some investors -- those for whom the costs of seeking such information are prohibitive (say, investors vacationing abroad) -- would not seek this information; but then, given their high costs, their refraining from seeking the information would presumably be socially desirable.

Consider now the issue of shareholders' incentive to seek information about the expected outcome of bids. It is true that the current unequal treatment provides shareholders with incentives to seek such information. Shareholders' seeking such information, however, is socially desirable only to the extent that it improves the efficiency of their tender decisions and, in turn, of bids' outcomes. Therefore, this issue cannot provide a ground for objecting to ensuring undistorted choice. For while at present shareholders might have more information about bids' expected outcome than they would have under the proposed regulations, their current tender decisions are subject to substantial distortions which the proposed regulations would eliminate; consequently, there can be no doubt that the proposed regulations would increase the efficiency of bids' outcomes.

My position is not, I wish to emphasize, that in regulating capital markets we should generally seek to equalize investors' returns and prevent sophisticated investors from faring better than unsophisticated ones. Market professionals and sophisticated investors engage in several socially valuable activities -- for example, their search for undervalued securities contributes to efficient market pricing, and arbitrage activity (which will be presently considered) improves the allocation of risk. These socially beneficial activities of sophisticated investors should be, and generally are, rewarded. My point is merely that in the takeover context there is no efficiency gain to be made by providing sophisticated shareholders with more than their prorata share of the acquisition price.

d. Arbitrage Activity

Let us now consider whether ensuring undistorted choice might have a significant adverse effect on the activity of arbitrageurs -- market professionals and sophisticated investors who purchase target shares in the market during the period in which the offer is open.152/ During that period, the target's shareholders face considerable uncertainty -- for example, the bid might or might not be obstructed by defensive tactics, or it might or might not be superseded by a higher bid. The arbitrageurs serve a socially beneficial role by enabling risk-averse shareholders of the target to pass the risk to parties who are better able to bear it. Consequently, one might be concerned that the proposed regulations would reduce arbitrage activity to an inadequate level.

One way in which ensuring undistorted choice might reduce arbitrage activity is by eliminating some of the current sources of uncertainty. The

---

152/ A concern that ensuring equal treatment might have such an effect on arbitrage activity is expressed in DeMott, supra note 120, at 1003.

proposed ban on obstructing tactics would of course eliminate the risk of bids being obstructed, and the proposed regulations would eliminate the risk of being stuck with minority shares. Note first that, since ensuring undistorted choice would also add some sources of uncertainty (e.g., the uncertainty as to whether a majority would make approving tenders or not), it might or might not reduce the overall amount of uncertainty. The important point, however, is this: supposing that undistorted choice, by decreasing the amount of uncertainty, would reduce arbitrage activity, that effect would provide no reason for opposing undistorted choice. For arbitrage activity is desirable only to the extent that it eliminates risk bearing costs. And a reduction in the amount of arbitrage activity which is induced by a decrease in the level of potential risk-bearing costs is not socially undesirable.

Another way in which the proposed regulations would affect arbitrageurs is by preventing them from capturing more than their prorata share of the acquisition price. Again, however, this would not reduce arbitrage activity to an inadequate level. To induce the desirable level of arbitrage activity it is not necessary to reward arbitrageurs for things, and in ways, that have nothing to do with their useful economic function -- to bear risk. As long as arbitrage transactions can produce efficiency gains by reducing risk-bearing costs -- that is, by transferring shares to parties that are better able to bear risk than the shares' current owners -- these transactions would take place. Thus, it would not be necessary to provide arbitrageurs with more than their prorata share of the acquisition price in order to induce the desirable level of arbitrage activity.

## B. Equal Treatment

I wish now to explain why equal treatment is desirable, not only as an instrument of ensuring undistorted choice, but also by itself, as an independent objective. As was explained, in current takeovers there are two groups of non-tendering shareholders who would wish to receive their prorata share of the acquisition price but instead have all their shares become minority shares: shareholders who lacked an opportunity to tender, and shareholders who did not tender because they hoped that the bid would fail.[153/] As I explain below, the unequal treatment of these shareholders is both inefficient and unfair.

1. Risk-Bearing Considerations

Let us first assume, unrealistically, that the identity of the beneficiaries and victims of the current unequal treatment is determined in a perfectly random fashion. That is, let us assume that all of a given target's shareholders have in case of a takeover an equal chance of being a beneficiary of the expected unequal treatment. Every share of the target might be thus viewed as carrying with itself a lottery ticket: the expected value of the ticket is the share's prorata fraction of the total acquisition price; and the ticket might bring the share's owner more or less than this expected value, depending on whether the owner turns out to be a beneficiary or a victim of the acquisition price's disproportionate division.

Given the above assumption, all the shareholders would consent ex ante -- that is, before the "lottery's results" become known -- to replacing the unequal treatment regime by an equal treatment regime. In an equal treatment regime each shareholder would receive with certainty his prorate fraction (of the acquisition price), which is equal to the expected value of what he receives

---

153/ See Part III, Section D. There is a third group of non-tendering shareholders who receive less than their prorata share -- those who did not tender for tax reasons. But in criticizing the current unequal treatment I abstract from this group of shareholders because they do not wish to be equally treated -- they prefer retaining minority shares in the taken over target to selling them for the bid's price.

in the unequal treatment regime. Thus, the only effect of adopting an equal treatment regime would be to eliminate all downward and upward risk, and thus to eliminate the present risk-bearing costs. Most shareholders are presumably risk-averse and would welcome the elimination of uncertainty. And those shareholders who are indifferent to the presence of uncertainty, say because they hold perfectly diversified portfolios, would be indifferent to adopting an equal treatment regime. In sum, by eliminating all risk-bearing costs the adoption of an equal treatment regime would make most shareholders better off and no shareholders worse off.

I shall presently explain that, in contrast to what we have thus far assumed, shareholders' fortunes in the current unequal treatment regime are not determined by a pure chance, and that some of them can expect to fare much better than others. Consequently, it will be seen that the adoption of an equal treatment regime is unlikely to enjoy a uniform consent by all shareholders. But the above analysis does suggest a clear efficiency consideration in favor of an equal treatment regime: as long as there is <u>some</u> element of randomness in determining shareholders' fortunes under the current unequal treatment regime, ensuring equal treatment would produce efficiency gains by eliminating risk-bearing costs.

2. <u>Fairness Considerations</u>

a. <u>The Problem of Distribution</u>

Shareholders' fortunes in the current unequal treatment regime are not determined by pure chance. Rather, some shareholders can expect to come out ahead, and, conversely, others can expect to fall behind. Whether a shareholder ends up with more or less than his prorata share of the acquisition price might well depend on the extent to which he is a professional, on his access to the market and to market information, and on his resources. I shall refer to these capabilities and characteristics as "sophistication," and I shall correspondingly refer to investors as "sophisticated" and "unsophisticated".

There are two reasons as to why, in the current unequal treatment regime, a shareholder's sophistication might affect his chances of receiving more than his prorata share of the acquisition price. First, sophisticated investors are very unlikely to ever lack an opportunity to tender, as they are usually both aware of available bids and capable of tendering their shares in time; in contrast, the possibility of lacking an opportunity to tender is a real one for unsophisticated investors. Second, when a bid is successful, sophisticated investors are much less likely than unsophisticated ones to have chosen not to tender due to a (false) hope that the bid would fail. Sophisticated investors have access to information that enables them to better determine a given bid's chances of being successful; and they are capable of tendering in the last moment, just before the bid is closed, on the basis of the most recent information concerning the bid's favorable chances of being successful.154/

Thus, in the current unequal treatment regime some sophisticated shareholders might have very favorable chances, if not virtual certainty, of benefiting from the expected inequality of treatment. Adopting an equal treatment regime would thus make these sophisticated shareholders worse off, and would hence produce not only gainers but also losers. To be sure, the gains would exceed the losses, as the equal treatment regime would produce overall efficiency gains by eliminating both the distortions of shareholder choice and the existing risk-bearing costs. But it clearly cannot be claimed that adopting the equal

---

154/ *See* Advisory Committee Report, *supra* note 10, at 52. Sophisticated investors have access to general market information, and some of them may also have the opportunity to monitor customers' tender decisions.

treatment regime would be a Pareto-superior move. Hence, a distributional issue emerges.

To be sure, there are some who believe that legal rules should be chosen solely on the basis of efficiency considerations.[155] Those who hold such a view should clearly support the adoption of an equal treatment regime, since such a regime would enhance efficiency by eliminating choice distortions and risk-bearing costs. On my view, however, and it is a view that I believe is shared by many, the distributional consequences of legal rules should be taken into account, and should often be given a substantial weight.

Below I shall therefore discuss and evaluate the distributive consequences of adopting an equal treatment regime. I shall argue that the distribution of the acquisition price that an equal treatment regime would produce is the one which is suggested by a widely shared sense of fairness and distributive justice. At the outset, I wish to emphasize that I shall not attempt to do the impossible -- to infer from indisputable premises, and through a process of compelling deductive logic, the fairness of a certain distribution. Rather, my argument will rely on certain moral intuitions and considered judgments of justice that I have. These intuitions and judgments, however, are ones that seem to be very widely shared, and to inform most of the currently dominant political theories.

b. The Presumption in Favor of Equal Treatment

It is a widely held moral principle that, absent any reason to the contrary, individuals in like situations should be treated alike.[156] This pre-

---

155/ See, e.g., R. Posner, The Economics of Justice (1982), ch.3, 4.

156/ See, e.g., Berlin, Equality, 56 Proceedings of the Aristotelian Society 281 (1956); J. Pennock & C. Chapman, Nomos IX: Equality (1967).

sumption is shared by all liberal political theories, and I trust by most readers as well. The presumption is rooted in a view that individuals are equal in some fundamental sense, and that claims for natural superiority must be rejected.

The presumption is a fairly weak one; indeed, it is its weakness that explains how it might be shared by so many people who sharply disagree with each other on many, if not most, political issues. What the presumption actually requires depends crucially on what one recognizes as like situations, and on what one acknowledges as appropriate reasons for deviating from alike treatment. Having accepted the presumption, one can still always argue for an unequal treatment in a given context by alleging some differentiating feature or overriding reason. Nonetheless, the presumption is not meaningless. While it does not determine one's conclusions, it does provide a starting point for one's reasoning, and it forces this reasoning to proceed in a certain way.157/

Let us now turn to the question of the distribution of the acquisition price when an independent public corporation is acquired. How should two shareholders who hold the same number of the target's shares be treated? At least at first glance, the two shareholders appear to be similarly situated with regard to the distribution of the acquisition price. Their shareholderings represent the same capital contribution to the corporation. And if the target were to remain independent, the two shareholders would be entitled to the same fraction of the target's distributed earnings. Thus, unless we can identify either a morally relevant feature to distinguish between these two shareholders, or some adequate reason for refuting the presumption of equality in the considered context, fairness would require that the two shareholder receive the same fraction of the acquisition price.

---

157/ For a good discussion of the weakness -- but meaningfulness -- of the considered presumption, *see* Bernard Williams, "The Idea of Equality," in Laslett & Runciman (ed.), Philosophy, *Politics and Society* (Second Series), pp. 110-31.

When an independent target is acquired through a merger, the merger consideration is generally distributed among the shareholders prorata. Shareholders receive the same per share consideration regardless of whether they voted for the proposal, against it, or did not participate in the vote. Thus, the law's implicit judgment is that, at least in the case of a merger, there exists no adequate reason for deviating from a proportionate division. The question we confront is whether the case of a takeover of an independent target is any different. Are there in the case of a takeover any reasons -- presumably ones not present in the merger context -- which refute the presumption that the fair division is a proportionate one? Below I shall consider the three kinds of considerations that are most commonly advanced to justify deviations from equal treatment. And I shall argue that in the takeover context these reasons do not justify a deviation from an equal treatment, but rather strengthen the case for an equality of treatment.

### c. Unequal Treatment Cannot be Justified By Efficiency Considerations

In the various contexts where a deviation from equal treatment is considered, the most frequently used argument for such a deviation is an efficiency argument, one that is based on the alleged efficiency gains that an unequal treatment would produce. In the considered takeover context, an efficiency argument for a disproportionate division has been made by Professors Easterbrook and Fischel.[158]

Supposing that an unequal treatment would indeed produce efficiency gains, there are two ways in which these potential gains might be thought to justify such an unequal treatment. First, it might be possible that the effi-

---

158/ See Easterbrook & Fischel, supra note 22.

ciency gains would have a way of trickling down, so that even those who would seem to be hurt by the unequal treatment would in reality be made better off by it. This is the argument that Esterbrook and Fischel made in the takeover context: they suggested that a deviation from a proportionate division was so essential for the efficient operation of takeovers that even investors who appear to be hurt by unequal treatment would have ex ante preferred an unequal treatment regime to an equal treatment one. Alternatively, it might be argued that even if a deviation from equal treatment in the considered context does produce losers such a deviation is still justified -- either because a consistent policy of realizing efficiency gains wherever possible might on the whole work in everybody's benefit, or because the efficiency gains might be sufficiently desirable by themselves to override parties' claims for an equal treatment.

Whichever form the efficiency argument takes, the argument of course depends on showing that a deviation from equal treatment in the considered context would be indeed likely to produce efficiency gains. But this is not the case, I suggest, in the takeover context.

As I have explained, an equal treatment regime would substantially contribute to efficiency in two ways: by enabling target shareholders to exercise an undistorted choice, and by eliminating risk-bearing costs. And, I have also explained, an equal treatment regime would be unlikely to involve any substantial efficiency costs. Thus, an equal treatment regime would on the whole substantially contribute to efficiency. Hence, efficiency considerations do not provide a reason for deviating from equal treatment, but rather strengthen the case for an equal treatment regime.

d. Unequal Treatment cannot be Justified by Entitlement or Desert Notions

Let us now turn to consider whether a deviation from equal treatment might be justified by an argument based on notions of desert or entitlement. The reason why two shareholders who own the same number of shares might currently end up with different fractions of the acquisition price is that they differ in their actions. It might be argued that this difference in actions is a morally significant one; and that consequently the two shareholders do not present a case of like situations which would trigger the equal treatment presumption. Because the current distribution of the acquisition price is a result of shareholders' voluntary actions, so the argument goes, those who end up with more than their prorata fraction deserve, or are entitled to, that which they receive.

Entitlement or desert arguments usually involve a claim that the party who is argued to deserve the considered object (or to be entitled to it) has made an essential contribution to creating that object. And it is thus important to note that such a claim cannot be made in our context. The activities that enable sophisticated investors to receive a disproportionately large share of the acquisition price are not essential to providing the target's shareholders with the takeover premium. For in the equal treatment regime that I have put forward target shareholders would still realize all potential premiums from beneficial, value-maximizing acquisitions.

Similarly, it cannot be maintained that the current distribution of the acquisition price is an integral part of the way in which takeovers must by their nature proceed, and that equal treatment should thus be viewed as an attempt to alter this "natural" distribution. The advantage that sophisticated shareholders currently have is simply a product of current takeover rules. Under the takeover rules that I proposed, investors' sophistication would play no role, and the distribution that would "naturally" emerge out of the takeover process would be a proportionate one.

Our question, then, is not whether sophisticated investors are entitled to retain what current takeover rules enable them to get; but rather whether or not these rules should be designed in the first place in such a way that investors' sophistication would matter. As I already explained, efficiency considerations provide no reason for enabling sophisticated investors to receive more than their prorata share of the acquisition price. The question here, however, is whether sophisticated investors are for some reason entitled to, or deserve, a system of rules in which they will have an advantage. This question must in the end come down to one's moral intuition as to what constitutes a morally relevant distinction. In my judgment, and I believe in that of most readers as well, the answer is clear: differences in sophistication do not by themselves provide a morally adequate reason to treat differently two shareholders who hold an equal number of shares; to assert that sophistication in investment by itself entitles one to superior treatment is almost as morally arbitrary as to assert that shareholders whose last name starts with an "A" deserve such a superior treatment.

e. Unequal Treatment Cannot be Justified by its Effect on the Overall Distribution of Income

Several dominant political theories, and I trust many of the readers, hold that the distribution of income arising out of the market should be corrected, and that income should be redistributed in some way from the well-off to the less well-off. The third kind of argument for unequal treatment that I wish to consider is an argument that seeks to justify unequal treatment in a particular context by reference to some overall distributive goals. One way in which the argument can be put is to say that differences in wealth among parties in the considered context are morally relevant, and that consequently parties with different levels of wealth should not be viewed as being in like situations. Another form of the argument accepts that the parties in the considered context are in like situations, but claims that in the considered context the equal treatment presumption is overriden because a certain unequal treatment (in favor of the less well-off) would serve a deeper and more comprehensive ideal of equality.

There is a substantial disagreement as to whether overall distributional goals should be taken into account in the design of legal rules, or should be left to the tax system.159/ But whatever position one takes on this large question, it is clear, I suggest, that a disproportionate division of the acquisition price in takeovers cannot be justified by reference to an overall goal of redistributing income. For the effect of the current disproportionate division on the overall distribution of income is likely to be regressive. The disproportionate division makes sophisticated investors better off and unsophisticated investors worse off than they would be in an equal treatment regime. And sophistication in investment appears to be positively correlated with wealth and income.160/

Indeed, the regressive impact that the current unequal treatment has on the overall distribution of income might be viewed as strengthening the case

---

159/ For a sample of different views on this issue, see, e.g., Ackerman, Regulating Slum Housing Markets on Behalf of the Poor: Of Housing Codes, Housing Subsidies and Income Redistribution Policy, 80 Yale L.J. 1093 (1973); Kronman, Contract Law and Distributive Justice, 89 Yale L.J. 472 (1980); Rawls, The Basic Structure as Subject, in Values and Morals 47, 54-55 (A. Golman & J. Kim eds. 1978); Posner, The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication, 8 Hofstra L. Rev. 487.

160/ See Feldstein & Yitzhaki, Are High Income Individuals Better Stock Market Investors? (Harvard Inst. of Econ. Research Discussion Paper No. 918, Sept. 1982).

for an equal treatment regime. I do not wish to imply that the beneficial distributive effect of the equal treatment regime would be sufficient to establish the desirability of this regime. It would not, for example, if the equal treatment regime involved substantial efficiency costs. In the considered takeover context, however, there is no conflict whatsoever between the consideration of redistributing income and the other relevant considerations. The equal treatment regime contributes to efficiency, and it is consistent with, if not required by, the fairness principle of treating like parties alike. The distributional impact of the equal treatment regime merely enhances the attractiveness of this regime, adding to the already strong case for it.

## VII. EXTENSION: ACQUISITIONS THROUGH OPEN MARKET OR PRIVATELY NEGOTIATED PURCHASES

The undistorted choice and equal treatment objectives, I proposed, should guide us in regulating all acquisition attempts, not only takeover bids. Now, at present a prospective buyer might attempt to gain control over a target not only through a takeover or a merger, but also through a third available acquisition method: acquiring a controlling interest through open market or privately negotiated purchases. This Part extends the Article's analysis to this third mode of corporate acquisition. I shall propose that, to ensure undistorted choice and equal treatment in corporate acquisitions, a prospective buyer seeking to gain control over a target should be limited to pursuing either a takeover or a merger.

Before proceeding, it is worth reminding that the Article's analysis is limited to attempts to gain control of companies which prior to the attempt were not controlled by a single shareholder (or a group of shareholders acting in concert). Thus, the analysis below will not apply to cases where a prospective buyer acquires a controlling interest by purchasing the shares of a single shareholder who currently controls the target. The analysis will apply only to cases where the prospective buyer purchases many non-controlling blocks (on the open market or through private negotiations) and combines them to a controlling block.

To start with the present situation, current law imposes very few restrictions on a prospective buyer's attempt to gain control over a target through open market or privately negotiated transactions.[161/] The main requirement is one of disclosure: Section 13(d)(1) of the Williams Act requires disclosure of the

161/ See Green & Junewicz, supra note 9, at 662-670; SEC Release, supra Note 11, at 86,918.

identity and intention of any buyer that obtains more than five percent of a company's stock.[162/] As explained below, the current ability of prospective buyers to acquire a controlling interest through open market or privately negotiated purchases leads to distorted choice and unequal treatment.

To examine the consequences of prospective buyers' use of the considered acquisition method, it will be useful to take up an example. Suppose, then, that a prospective buyer seeks a controlling block of 40% of a target's shares; and suppose that to this end the buyer privately approaches various shareholders and offers to buy their holdings for $100 a share (the analysis of the case of open market purchases would be essentially the same). Suppose also that if the prospective buyer does succeed in acquiring the controlling block, the value of shares not held by the buyer will be $80 a share. Thus, if the considered acquisition attempt succeeds, the per share acquisition price will be $88 a share.

The outcome of the considered acquisition attempt might deviate from that which is suggested by the undistorted choice objective. That is, the buyer might well succeed in gaining control even if a majority of the target's shareholders view the independent target's per share value (including the prospect of future acquisition attempts) as higher than the $88 expected per share acquisition price. The reasons for the possible distorted choice are quite similar to those that would possibly lead to a distorted outcome if the buyer chose to make a $100 a share partial bid for the 40% block sought.

The most important reason as to why the outcome of the considered acquisition attempt might be distorted is the fact that a shareholder approached by the prospective acquirer might well elect to sell his shares to the buyer even if he views the independent target's per share value as higher than the $88

---

162/ U.S.C. § 78(d)(1)(1976).

expected per share acquisition price. First, if the shareholder views the independent target's per share value as lower than the $100, he will certainly agree to sell his shares (regardless of the likelihood that he attaches to the possibility of the buyer gaining control). Moreover, the shareholder might agree to sell his shares even if his estimate of the independent target's per share value exceeds $100. For the shareholder might know, from the required disclosure and from the very fact that the buyer approached him, that the buyer might be seeking to gain control; and supposing that the buyer is going to gain control, the shareholder will be better off selling his shares for the offered $100 a share no matter how high his estimate of the independent target's per share value.163/

Turning to the problem of unequal treatment, I wish to point out that if the buyer in the considered example succeeds in gaining control, the acquisition price (of $88 per share) will be distributed among the target's shareholders quite disproportionately. Shareholders who sold their shares to the buyer will end up with $100 per share, while those who were not approached by the buyer or were approached but did not agree to sell will end up with shares in the taken over target worth $80 a share. Indeed, this inequality of treatment will probably be even greater than the one that would result if the buyer gained control through a partial bid for 40% of the target's shares. For a successful partial bid would likely attract tenders from more than 40% of the

---

163/ The main source of the current distortions, then, is the fact that shareholders' decisions to sell their shares to the buyer do not necessarily reflect a judgment that the independent target's per share value is lower than the expected per share acquisition price. In addition, the problem of effective control adds to the current distortions, in the same way as it does in current takeover bids: even if shareholders' decisions whether or not to sell their shares reflected a judgment that the independent target's value is lower than the expected acquisition price, the buyer's ability to gain control by purchasing less than a majority of shares might by itself lead to a distorted choice.

shareholders; consequently, more than 40% of the shareholders (though not all of them) would have some of their shares acquired for $100 a share.

In sum, current attempts by prospective buyers to gain control over a target through open market or privately negotiated purchases lead to distorted choice and unequal treatment. The objectives of undistorted choice and equal treatment therefore suggest that this acquisition method should be prohibited. A prospective buyer seeking to acquire a controlling interest should be limited to pursuing the avenue of a takeover (subject, of course, to the regulations proposed in Part V) or of a merger. That is, accumulation of shares through open market or privately negotiated transactions should be prohibited from going beyond the specified threshold of a controlling interest. This rule, together with the proposed takeover rules, would work to ensure undistorted choice and equal treatment.

The above rule, which I have derived from the general theoretical framework that the Article has put forward, is one that has been frequently proposed. Such a rule is contained in the British City Code,164/ was proposed by the SEC several years ago,165/ and has been endorsed by various commentators.166/ The SEC's Advisory Committee recommended such a rule.167/ Support for adopting such a rule thus seems widespread, though there is naturally disagreement as to the threshold at which effective control should be assumed to pass.168/

---

164/ See The City Code, supra note 104, Rule 34.

165/ See SEC Release No. 34-16385 44 Fed. Reg. 70, 326 (1979); S. 3188, 96th Cong. 2d sess. (1980). In the end, however, the proposed rule was not adopted, and the proposed legislation was not enacted.

166/ See, e.g., Green & Junewicz, supra note 9, at 673-676.

167/ See Advisory Committee Report, supra note 10, at 22-23.

168/ Id., at 23.

But the SEC, reacting to the Advisory Committee's recommendation, stated that it had serious reservation about this recommendation, and that the issue required further study.[169/]

The desirability of the considered rule directly follows from the preceding Part's demonstration that undistorted choice and equal treatment are beneficial and that ensuring them would be likely to involve no substantial social costs. Still, it might be worthwhile to specifically address the concern that the SEC expressed with respect to the considered rule.[170/] The SEC was worried about the economic implications of the fact that the rule would often increase the cost of purchasing a block larger than the specified threshold. This would be the case, the Committee pointed out, whether the buyer seeks to purchase the block for control purposes or for other reasons (e.g., investment or technology transfer).

Now, to be sure, the considered rule would often increase the price that a buyer would have to pay to acquire a block larger than the specified threshold. But this provides no reason to oppose the rule, much the same way that the effect of the proposed takeover rules on acquisition prices provides no reason to oppose these rules. As I explained, increased prices do not by themselves represent a social cost, and they are socially undesirable only to the extent that they lead parties to behave inefficiently. The considered rule would not eliminate any socially beneficial acquisition of a block -- that is, any acquisition of a block that should take place from a social point of view. The only instances where the rule would prevent an acquisition of a block (whether sought for the purpose of control, investment, technology transfer,

---

169/ See Statement of Shad, supra note 11, at 86,679. The SEC then invited comments from the public on the issue. See SEC Release, supra note 11.

170/ See SEC Release, supra note 11, at 86, 919.

or any other reason) are those where in the view of a majority of the target's shareholders the price offered for the block is less than what they are asked to give up. And in these instances it is indeed socially desirable, as I have explained, that the attempted acquisition of the block will not take place.

## VIII. BEYOND UNDISTORTED CHOICE AND EQUAL TREATMENT

The analysis of this Article has focussed on the objectives of undistorted choice and equal treatment, or, alternatively, on addressing the current problems of distorted choice and unequal treatment. These two closely related problems are rooted in the divided, often dispersed ownership of acquisition targets. I wish now to note the existence of some other problems concerning corporate acquisitions, problems which I have ignored throughout the Article's analysis. Addressing these problems, which I shall presently describe, is an additional objective for acquisition rules -- beyond the proposed objectives of undistorted choice and equal treatment. My aim in this brief Part is to show that these additional problems do not undermine or weaken the case for the regulations that I have put forward, but rather suggest that these regulations might have to be supplemented by some additional measures.

To understand the full scope of potential problems concerning corporate acquisition, I wish to state three conditions that together would ensure that the corporate acquisitions market would allocate target assets efficiently. The three conditions are: (i) undistorted choice by targets -- a target will be acquired if and only if the expected acquisition price is higher than the independent target's value; (ii) undistorted choice by acquirers -- a target will be acquired if and only if the expected acquisition price is lower than the target's value to the acquirer; and (iii) no externalities -- the private gains that the acquisition confers on the acquirer's and the target's shareholders represent social gains (i.e., they do not come at the expense of, for example, consumers, taxpayers, or employees).

Now, the Article's analysis has focussed on the current violation of condition (i) -- that is, on the current distorted choice of target shareholders;

and the regulations that the article has put forward would ensure that condition (i) would hold -- that is, would ensure an undistorted choice by target shareholders. Throughout, I have implicitly assumed that conditions (ii) and (iii) currently hold -- that is, that bidders' choices are undistorted, and that the private gains to bidders' and targets' shareholders do represent social gains. Assuming that conditions (ii) and (iii) do hold, the proposed regulations would by themselves ensure an efficient allocation of targets' assets.

The assumption that conditions (ii) and (iii) do currently hold has been useful in enabling the present inquiry to focus on the distorted choice problem. But, as I point out below, this assumption does not generally hold.

Consider first condition (ii) -- that bidders' choices be undistorted. I have implicitly assumed that in every acquisition attempt the expected acquisition price is in the prospective acquirer's view (that is, in the view of the acquirer's management) lower than the target's value to the bidder. This, however, need not be the case. A divergence of interests between shareholders and managers might occur not only in targets, but also in acquirers. While a company's shareholders are solely interested in maximizing the value of the company's shares, the managers might also be interested in expanding the size of the enterprise under their control.171/ Consequently, the acquirer's management might be willing to pay for the target an acquisition price exceeding the target's value to the acquirer. Consequently, ensuring undistorted choice by target shareholders would not rule out an acquisition of a target whose independent value exceeds its value to the acquirer. For the acquirer's management might

---

171/ See, e.g., W. Baumol, Business Behavior, Value and Growth 45-52 (rev.ed. 1967); R. Marris, The Economic Theory of "Managerial" Capitalism 122-24 (1964); Marris & Mueller, The Corporation, Competition, and the Invisible Hand, 18 J. Econ. Literature 32, 41-45 (1980).

elect to raise the offered acquisition price beyond both the target's value to the acquirer and the target's independant value, and the (socially undesirable) acquisition might hence take place.

Consider now condition (iii) -- that private gains (from an acquisition) to the acquirer's and the target's shareholders represent net social gains. Supposing that a given acquisition reflects an undistorted choice from the perspective of both the target and the acquirer, the acquisition will increase their combined value and benefit their shareholders. This, however, would by itself imply that the acquisition is socially desirable only if the gains to the acquirer's and target's shareholders indeed represent social gains. At present, however, private gains to the acquirer's and the target's shareholders need not reflect social gains. To be sure, the increase in the combined value of the target and the acquirer might be the result of improved management or synergy, in which case the private gains will indeed reflect social gains. But the increase in value might also result from tax savings,[172/] or enhanced market power,[173/] in which case the private gains will come at the expense of tax revenues and consumers. Furthermore, some acquisitions might impose substantial costs on communities and employees, costs which the decision-makers will not take into account. Thus, some current acquisitions might be socially undesirable even though they increase the combined value of the acquirer and target.

One could examine various ways to address the above two problems. For example, to address the problem of potential distorted choice by acquirers, one might consider the possibility of requiring that acquisition bids (or at least some of them) be approved by the prospective acquirer's shareholders.[174/]

---

172/ See, e.g., P. Steiner, Mergers: Motives, Effects, Policies 75-95 (1975).

173/ Ibid., at 69-74, 218-87.

174/ See Coffee, supra note 7, at 1269-72.

And, to address the problem of private gains that do not reflect social gains, one might seek to design measures that would discourage and curtail acquisitions that are motivated by tax savings or increased market power, or that impose substantial costs on communities and employees. But in any event, addressing the above two problems is a complex task which is beyond the scope of the present Article. Here I only wish to point out that the presence of the two considered problems does not undermine the case for the regulations that the Article has put forward.

At present, the three stated conditions that would ensure efficient allocation of target assets do not hold, and, consequently, socially undesirable acquisitions do often occur. The proposed regulations would ensure that a target would not be taken over if its shareholders view the expected acquisition price as lower than the independent target's value. The regulations would hence prevent some socially undesirable acquisitions from taking place. Now, the presence of the two problems considered in this Part -- the possible distorted choice by acquirers, and the possible divergence between private and social gains -- does not imply that the acquisitions which the proposed regulations would prevent might be socially desirable. Rather, the presence of these problems suggests that the proposed regulations would not prevent all socially undesirable acquisitions, or, in other words, that some socially undesirable acquisitions would continue to take place even after the proposed regulations are adopted. It follows that the presence of these two problems provides no basis for opposing the proposed regulations, but rather suggests that it might be desirable to supplement these regulations with some additional measures.

## IX. CONCLUSION

This Article has proposed two objectives -- undistorted choice and equal treatment -- for acquisition rules in general, and for takeover rules in particular. I have shown that undistorted choice would materially contribute to the efficient allocation of corporate assets; that equal treatment would be necessary to attaining undistorted choice, would eliminate risk-bearing costs, and is suggested by widely shared notions of fairness; and that ensuring undistorted choice and equal treatment would not involve any substantial social costs.

The Article has also provided a comprehensive account of how the outcomes of current takeover bids deviate from what is suggested by the undistorted choice and equal treatment objectives. I have systematically analyzed the nature and operation of the current distortions and classified their several sources. The analysis has shown that the current distortions are more severe and pervasive than is commonly thought, and that various remedies which have been suggested in the literature would not adequately address the current problems.

Finally, the Article has put forward a regulatory framework that would adequately address the distorted choice and unequal treatment problems. I have shown that the proposed regulations would ensure undistorted choice and equal treatment; and that they would not prevent any socially beneficial acquisition or involve some other significant social costs.

While the Article's analysis has focussed on takeovers, the undistorted choice and equal treatment objectives were proposed for all acquisitions. Indeed, these objectives provide a unified normative framework for evaluating acquisition rules. I have pointed out that merger law is roughly consistent with the two proposed objectives. And, on the basis of the two objectives, I have suggested that prospective buyers should be prohibited from acquiring a controlling interest through open market or privately negotiated purchases, and hence should be limited to pursuing the avenues of a takeover or a merger.

The Article has thus established a normative framework, based on the undistorted choice and equal treatment objectives, for evaluating acquisition rules; and the Article has outlined several important elements of the acquisition rules that are suggested by the proposed normative framework. There are still several remaining issues, however, that have to be considered before we can put forward a complete set of desirable acquisition rules.

First, while I noted that merger law is roughly consistent with the proposed objectives, it is still necessary to conduct a systematic and detailed analysis of the objectives' implications for the various aspects and contours of merger law. Second, while I pointed out that the undistorted choice objective requires a ban on managers' use of obstructing defensive tactics, it is still necessary to carefully examine the objective's implications for the rules concerning the role of the target's management in the target's acquisition. Third, the proposed objectives and the Article's analysis have been limited to acquisitions of corporations that prior to the acquisition did not have a controlling shareholder; and it thus remains to extend the analysis to acquisition of corporations that do have such a shareholder. Finally, as I noted, in addition to the problems of distorted choice and unequal treatment, corporate acquisitions might present two other problems -- distorted choice by acquirers, and private gains to acquirers and targets that do not represent social gains. As I explained, while these problems do not weaken the case for the Article's proposed regulations, they might require -- and this is an issue which requires further study -- supplementing the proposed regulations with some additional measures. All these issues have to be examined before the task which this Article has pursued -- putting forward a complete set of desirable acquisition rules -- is brought to completion.

# APPENDIX: DISTORTED AND UNDISTORTED CHOICE IN BIDDING CONTESTS

In analyzing the outcome of takeover bids, I have throughout assumed that a given target's shareholders face a single bid, rather than competing bids. I have made this assumption in order to focus on target shareholders' choice between selling their company and remaining independent in isolation from the choice that they might face between rival bids. This Appendix extends the analysis to the case where competing bids are present. Below I shall show that at present target shareholders' choice among rival bids is distorted -- a bidder might take over a target even if a majority of the target's shareholders view the bidder's offered acquisition price as lower than the acquisition price offered by some other competing bidder. And I shall examine how the proposed regulations should be designed to facilitate undistorted choice among competing bids.

## A. The Current Distorted Choice

### 1. The Situation to be Examined

Below I shall examine a paradigmatic situation of a bidding contest over a target. The situation will be a stylized one, in that I shall use the following two simplifying assumptions. First, I shall assume that there are only two competing bidders, which I shall denote by A and B; without loss of generality, I shall suppose that A's offer expires prior to B's offer.[1/] Second, in order to focus on the choice of the target's shareholders between

1/ This does not imply that bidder A was the first one to make a bid for the target. For example, the considered bids might be the final ones in a long contest started by B.

A's offer and B's offer, I shall assume that all of the shareholders (who are all assumed to be aware of both bids) view the independent target's value as lower than both A's offered acquisition price and B's offered acquisition price. Section C will consider the additional complications that would be introduced once these two assumptions are dropped.

What is the socially desirable outcome in the considered situation? According to the undistorted choice objective, a takeover by A and a takeover by B are both superior to the target's remaining independent; for the independent target's value is lower (in the shareholders' view) than both A's offered acquisition price and B's offered acquisition price. Thus, the target should be acquired, and the question is only whether it should be acquired by A or by B. The acquirer's identity might be important from the perspective of efficiency because potential buyers might substantially differ in the value that they place on the target's assets.

Now, according to the undistorted choice objective, the socially desirable acquirer is that bidder whose offered acquisition price is viewed by a majority of the target's shareholders as the higher one. Using reasoning which by now should be familiar, the acquirer should be the bidder that places the highest value on the target and is therefore willing to pay the most for it. And where the shareholders differ in their judgment as to how the two offered acquisition prices compare,[2/] we should follow the majority's judgment, as the majority is more likely to be correct in its judgment.

Thus, according to the undistorted choice objective, bidder A should gain control if a majority of the shareholders view A's offered acquisition price

---

2/ For each of the two bids, shareholders might differ in their estimate of the value of offered securities, and in their estimate of the expected number of shares that in case of a takeover will be acquired for the bid's price.

as higher than B's, and B should gain control if the opposite is true. It is thus desirable that a shareholder tender to A if he judges A's offered acquisition price to be the higher one, and to B if he has the opposite view. As will be explained below, however, shareholders' current tender decisions in the considered situation might well deviate from the above standard of desirability.

## 2. Shareholders' Current Considerations

Let us examine a given shareholder's tender decision in the considered situation. The shareholder will presumably tender his shares, as will all other shareholders do,[3/] and the question is only whether the shareholder will elect to tender to A or to B. As the analysis below will demonstrate, the shareholder's choice will be determined by considerations other than his judgment as to whether or not A's offered acquisition price exceeds B's offered acquisition price.

The shareholder will realize that the expected effect of his tender decision on the contest's outcome is very small if not negligible. Consequently, he will mainly consider two possible outcomes: a takeover by A, or a takeover by B.[4/] I shall assume that both A and B retain the option not to purchase tendered shares in case that they fail to gain control. Consequently, whichever bidder proves to be successful, the losing bidder might elect not to purchase shares tendered to it.

---

3/ I assume that shareholders have no compelling tax reasons for avoiding a sale of their shares. Consequently, since any given shareholder is assumed to view the independent target's per share value as lower than both A's bid price and B's bid price, holding out altogether will never be his preferred strategy.

4/ In the analysis below, I shall for simplicity ignore the possibility that the tendering shareholders will divide themselves roughly equally between the two bids so that the contest will be deadlocked.

For each of the possible two cases, the shareholder will examine whether he will be better off tendering to A or to B. As will be seen, supposing A is going to win, the shareholder's best course of action will be to tender to A; and supposing B is going the win, the shareholder's best course of action will be to tender to B. That is, a victory by either bidder might impose a cost, a penalty, on tendering to the winner's competitor rather than to the winner. Therefore, in deciding whether to tender to A or to B, the shareholder will compare the two bids in terms of two factors: (i) the bid's likelihood of success; and (ii) the expected penalty that the bid's success will impose on tendering to the competing bid. Below I shall examine the factors that determine how the bids compare in terms of these two factors, and I shall start with factor (ii).

(a) <u>The Penalty that a Bid's Success will Impose on Tendering to the Rival Bid</u>

To focus on factor (ii), let us first suppose that the shareholder attaches the same probability to A's success and to B's success. Consequently, the shareholder's decision will be determined by his judgment as to whether or not A's success will impose a higher cost on tendering to B than the cost that B's success will impose on tendering to A.

Let us first assume that shares tendered to the failing bidder are expected to be returned to the tenderors and to become minority shares. In this case, the shareholder will compare (1) the gap between A's bid price and the expected value of minority shares in case of a takeover by A, with (2) the gap between B's bid price and the expected value of minority shares in case of a takeover by B. The shareholder will tender to A if (1) exceeds (2), and to B if the opposite is true. Thus, the bidder that will be best able to take advantage of minority shareholders upon gaining control will have an advantage. For a victory by this bidder will impose a higher penalty on tendering to its losing rival.

Thus far I have assumed that shares tendered to the losing bidder will all become minority shares. This assumption clearly holds when the winning bidder is A, the one whose offer closes earlier. In such a case, B will have no reason to purchase any tendered shares, and the returned shares will all become minority shares. But, as I explain below, in case that the failing bidder is A, shares tendered to A need not always become minority shares; and this might give A an advantage in the contest with B.

To see this, suppose that A's bid closes with insufficient number of shares for a takeover, and hence that it is expected that B will receive enough tenders to gain control. It is possible that the failing A will return tendered shares to the tenderors promptly so that they will be able to tender their shares in time to B's bid. Also, if B's bid is for all shares and with a bid price exceeding A's bid price, A will elect to purchase tendered shares in order to resell them to B. The presence of these two possibilities implies that in case A's bid is the one to fail, shareholders who tender to A might either bear no loss or bear a loss which will be smaller than the gap between B's bid price and the post-takeover value of minority shares. And this will give A an advantage in the contest with B over the target.

In sum, one consideration of the shareholder will be his judgment as to how the two bids compare in terms of the expected gap between the bid's price and the post-takeover value of minority shares in case the bid's succeed. This consideration will favor the bidder that will be best able to take advantage of minority shareholders upon gaining control. Another consideration, which will favor A, will be the possibility that in a takeover by B shares tendered to A might not become minority shares but rather might be purchased by A or returned in time to be tendered to B. Needless to say, these considerations have very little to do with the socially relevant consideration -- the shareholder's judgment as to how A's offered acquisition price compares with B's offered acqusition price.

(b) <u>The Likelihood of a Bid's Success</u>

Thus far I have assumed that the probability of A's victory is equal to the probability of B's victory. Once this assumption is dropped, we recognize the presence of another consideration which will importantly affect the shareholder's tender decision -- his judgment as to how these two probabilities compare. The greater the likelihood of a given bidder's success, then the greater the likelihood that the shareholder will elect to tender to this bidder rather than to its rival.

Now it might be thought by some that the shareholder will attach no likelihood of success to the bidder whose offered acquisition price the shareholder views as lower than that of the rival bidder. This, however, is not the case. The shareholder's estimate of a bid's likelihood of success might well be shaped by considerations that have little to do with his judgment as to how the bidders' offered acquisition prices compare.

In estimating the bids' likelihood of success, one relevant factor will be the shareholder's judgment as to how the two bids compare in terms of the expected penalty that their success will impose on tendering to the rival bid. For the shareholder knows that this comparison might well affect shareholders' tender decisions and hence the contest's outcome. Another important consideration that the shareholder will take into account is his judgment as to other shareholders' expectations concerning the contest's outcome. Indeed, any pervasive initial expectations that a given bidder will be the one to win might be self-fulfilling; and this by itself implies that, consistent with perfect shareholder rationality, the contest might end with a victory by the bidder whose offered acquisition price is lower.

## B. Attaining Undistorted Choice

The preceding discussion has demonstrated that under current rules the considered contest between A and B might end in a takeover by the bidder whose offered acquisition price is viewed by a majority of the shareholders as lower than that of the rival bidder. I wish now to explain how the proposed regulations can be extended to ensure undistorted choice between A's and B's bids.

One possible extension of the proposeds regulations would allow shareholders to tender their shares to both A and B. This approach would require rival bidders to have one, centralized depository. While shareholders would be able to tender to both A and B, they would be allowed to make an approving tender to only one of the rival bidders; indeed, a shareholder would have no reason to make approving tenders to both bidders. Thus, a shareholder who would make an approving tender to one of the bidders, whose victory the shareholder prefers, would be able to also make a disapproving tender to the rival bidder, to ensure receiving his prorata share of the acquisition price in case of a takeover by this rival bidder. As before, a bidder would be allowed to purchase a controlling interest only if it would attract approving tenders from a majority of the shareholders.

To verify that the above approach would work, note first that the shareholders in the examined situation would all elect to tender (approvingly or disapprovingly) to both A and B. Thus, whichever bidder wins the contest, all shareholders will receive their prorata share of the acquisition price. Now, consider a given shareholder's choice whether to make an approving tender to A or to B. The shareholder's choice will affect his position only in case that his choice will determine the contest's outcome. Consequently, the shareholder will make an approving tender to A rather than to B if and only if he prefers a takeover by A to a takeover by B. And as the acquisition price is expected to be divided prorata in case of a takeover by either bidder, the shareholder will prefer A's takeover to B's takeover if and only if he views A's offered acquisition price as higher than B's offered acquisition price. Thus, as the winning bidder will be the one who would receive approving tenders from a majority of the shareholders, the winner would be the one whose offered acquisition price is judged by the majority to be the highest available.

An alternative way in which the proposed regulations could be extended to ensure undistorted choice is as follows. If A, the bidder whose offer is the first to close, does not attract a majority of approving tenders, A would have to return unpurchased tendered shares in time for the tenderors to tender them to B. This approach would necessitate requiring rival bidders to maintain a sufficient time gap between the closing of their bids.

To verify that the above approach would work, note first that, once there is no risk that tendering to A would lead to one's shares becoming minority shares in case of a victory by B, all shareholders would tender (approvingly or disapprovingly) to A. Thus, if A gains control, the acquisition price will be distributed prorata. If A fails to attract the required number of approving tenders, then all shareholders will tender to B, which will presumably succeed in gaining control; again, the acquisition price in B's takeover will be distributed prorata. Thus, the contest's outcome will depend on whether or not A succeeds in attracting the required number of approving tenders. Now, consider a given shareholder's choice between tendering to A approvingly and disapprovingly. The shareholder's choice will affect his position only in case that his choice will determine the outcome of A's bid (and hence also the outcome of the contest). Consequently, the shareholder will make an approving tender to A if and only if he prefers a takeover by A to a takeover by B. And, as the acquisition price in a takeover by either A or B is expected to be divided prorata, the shareholder will prefer A's takeover to B's takeover if and only if he views A's offered acquisition price as higher than B's offered acquisition price.

## C. Undistorted Choice Among Three or More Outcomes

In closing, I wish to point out a problem that arises when the assumptions of the preceding analysis are dropped. The preceding analysis has assumed that a given target's shareholders face only two bidders, and that all the shareholders view the independent target's value as lower than the acquisition prices offered by both bidders. The implication of the above assumptions is that there are only two candidates for the socially desirable outcome -- a takeover by A, and a takeover by B. Once the above assumptions are dropped, however, there might be three or more candidates for the socially desirable outcome -- three or more outcomes each of which is viewed by some shareholders of the target as the value-maximizing outcome.

Suppose, for example, that in the examined situation some of the target's shareholders view the independent target's value as higher than both A's offered acquisition price and B's offered acquisition price. Thus, there are three outcomes which might be socially desirable -- a takeover by A, a takeover by B, and remaining independent. In this situation, a problem might arise. The problem is not one of ensuring that the socially desirable outcome would take place, but rather one of defining what the socially desirable outcome is.

For there might be no outcome which in the view of a majority of the target's shareholders is superior to the other two possible outcomes. It might so happen that the independent target's value is viewed by a majority of the shareholders as lower than A's offered acquisition price, that A's offered acquisition price is viewed by a (different) majority as lower than B's offered acquisition price, and, finally, that B's offered acquisition price is viewed by a (still different) majority as lower than the independent target's value.[5/]

How should the socially desirable outcome in the above situation be defined? Social choice theory suggests that the above problem cannot be perfectly solved.[6/] Whenever there are three or more candidates for the socially desirable outcome, there will be some contingencies where the adopted definition will have some arbitrary and imperfect element. The undistorted choice objective, as I defined it, requires that a bidder gain control if and only if, in the view of a majority of the target's shareholders, the bidder's offered acquisition price exceeds the independent target's value as well as other bidders' offered acquisition prices. The imperfection in this definition is that it is slightly biased in favor of the target's remaining independent. When there is no outcome which is viewed as superior to all others by a majority of the target's shareholders, the objective requires that the target remain independent.

---

5/ This will be the case, for example, if the distribution of estimates is as follows: One third of the shareholders view (i) A's offered acquisition price as higher than (ii) B's offered acquisition price and (iii) the independent target's value, and also view (ii) as higher than (iii); one third of the shareholders view (ii) as the highest among the three values, and (iii) as the second-highest; and one third of the shareholders view (iii) as the highest and (i) as the second-highest.

6/ *See generally* K. Arrow, Social Choice and Individual Values (2nd ed. 1963); D. Mueller, Public Choice (1979).

The proposed regulations (including the extensions outlined in Section B of this Appendix) would ensure that, in situations where no single outcome is viewed by a majority of the shareholders as superior to all other possible outcomes, the outcome would be that which is suggested by the distorted choice objective. Now, if we choose to define the desirable outcome in such problematic situations differently, we will have to slightly modify the proposed regulations (specifically, to modify the formula of the required number of approving tenders). But in any event, defining the socially desirable outcome in such problematic situations is not an issue of much practical importance. Such situations are presumably quite rare; and when they do occur, the difference in terms of efficiency between the candidates for the socially desirable outcome is likely to be quite small.